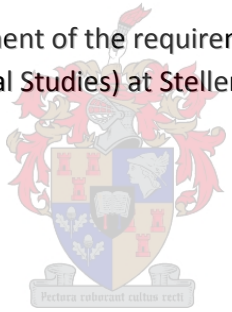
Investing in Troubled Territories

Industry Specific Political Risk Analysis and the Oil and Gas Industry

Marc James Boshoff

Thesis presented in partial fulfilment of the requirements for the degree of Master of Arts (International Studies) at Stellenbosch University



Supervisor: Ms Derica Lambrechts

Department of Political Science

March 2010

DECLARATION

By submitting this dissertation electronically, I declare that the entirety of the work contained therein is my own, original work, that I am the owner of the copyright thereof (unless to the extent explicitly otherwise stated) and that I have not previously in its entirety or in part submitted it for obtaining any qualification.

March 2010

ABSTRACT

The central research question of this study concerns the level of political risk that the Ogaden region of eastern Ethiopia poses for companies operating in, or intending to operating in the oil and gas industry of that region. The aim is to answer that question as well as two further sub-questions. The first sub-question concerns issues pertaining to the factors and indicators that would be included in a political risk model specifically envisaged for the oil and gas industry, and the second concerns the practical application of political risk as a decision-making and management tool for investors. It is practically impossible to gather all the relevant information when undertaking a political risk analysis, to know all the unknowns. It would take an immense amount of time to attempt such an analysis and the costs would be exorbitant. In creating a political risk model specific to the oil and gas industry, a methodological approach is adopted to streamline this process. It is the aim of this research study to engage in this streamlining process; selecting the most salient variables that can then be incorporated into an industry specific model, which will yield realistic and practical results. In terms of the political risk indication, the political risk analysis of the Ogden returned a score putting the region in the high risk indication bracket. In terms of investment indication, the score indicates a moderate to high risk for investments the oil and gas industry. This does not mean that investors should stay away from the region. A high degree of risk, if sufficiently managed, can result in increased opportunities for higher returns for the investor. Beyond the traditional approaches to risk management there are other avenues that the investor may choose to follow, such as a commitment to engage with local stakeholders. These initiatives should extend beyond mere financial incentives to a more genuine form of community interaction, with extensive local consultation. Strategies, policies, and procedures should be developed that ensure that companies engage productively with NGOs and the media at local levels in order create a suitable environment for all involved. Political risk is more than simply providing a report with a risk rating tagged to the end of it. It should be a fully integrated part of the investor's strategy, essential to the continued success and profitability of the investment.

OPSOMMING

Die sentrale navorsingsvraag van hierdie studie handel oor die vlak van politieke risiko wat maatskappye wat besigheidsbelange in die Ogaden streek van oos Ethiopië het, of wat beplan om besigheidsbelange in die olie- en gasbedryf te begin, in die gesig staar. Die doel is om die vlak van politieke risiko te identifiseer en om verder twee sub-vrae te beantwoord. Die eerste sub-vraag is om die faktore en indikatore te identifiseer wat deel sal vorm van ‘n politieke risikomodel, spesifiek vir die olie- en gasbedryf en die tweede handel oor die praktiese aanwending van politieke risiko as ’n besluitnemings- en risikobestuur-instrument vir beleggers. Dit is prakties onmoontlik om alle relevante informasie in te samel wanneer ’n politieke risiko-analise gedoen word, of om bewus te wees van al die onbekende aspekte. Dit sal ‘n ongelooflike lang tydperk neem asook die kostes sal uiters hoog wees. Wanneer ‘n politieke risikomodel spesifiek vir die olie- en gasindustrie gebou word, word ’n metodologiese benadering om die proses te vergemaklik gevolg. Dit is die doel van hierdie studie om by te dra tot die vereenvoudiging van hierdie metodologiese proses deur die mees prominente aspekte te selekteer wat gevolglik geïnkorporeer kan word in ‘n industrie spesifieke model. Die model sal beide realistiese en praktiese resultate bied. Ten opsigte van die skaal vir belegging en politieke risiko indikasie, het politieke risiko analise van die Ogaden gedui op ’n hoë risiko indikasievlak. Vir belegging dui die risikovlak op ’n medium tot hoë risikovlak vir die olie- en gasindustrie. Dit beteken nie dat beleggers die area noodwendig moet vermy nie. Indien ’n hoë risikovlak aanwesig is, kan suksesvolle bestuur steeds verhoogde winsgeleenthede vir die belegger verseker. Behalwe vir die tradisionele benaderings tot risikobestuur en risikomitigasie is daar ook ander moontlikhede wat die belegger kan volg om die vlak van risiko te verlaag, soos ’n ooreenkoms om saam met plaaslike belanghebbendes te werk. Sulke meganismes moet verby finansiële belonings strek en ‘n opregte vorm van gemeenskapsinteraksie aanneem wat net kan gebeur deur middel van uitgebreide plaaslike konsultasie. Strategie, beleid en prosedure moet ontwikkel word, wat sal verseker dat maatskappye optimaal saamwerk met nie-regerings-organisasies en die media op plaaslike vlak. Dit sal verseker dat ’n geskikte omgewing vir alle partye geskep word. Poltieke risiko is veel meer as net risiko-evaluasie waar ’n vlak van risiko verskaf word. Dit behoort ten volle deel te wees van die belegging en is essensieël tot die sukses en winsvlak vir die belegger.

ACKNOWLEDGMENTS

I would like to thank my family, in particular my parents, for their continued and unwavering support and understanding, without which I would not have been able to undertake this additional research study. Their effortless trust and belief in me has at times come as a surprise, and has both overwhelmed and left me with an unparalleled sense of appreciation for who they are and what they have been through for me. I would also like to thank my supervisor, Ms Derica Lambrechts, for her extensive insights and understandings of political risk, and for her enduring patience. It is only with her support, motivation, and resolute efforts that this thesis has been completed to a level that has exceeded my expectations. Finally, I would like to thank the Department of Political Science at Stellenbosch University, the academic and administrative staff, and all my fellow students, especially Ms Anneke Kamphuis, for her support, motivation, and competitive spirit, all of which have spurred me to new heights throughout this experience.

CONTENTS

LIST OF TABLES, FIGURES AND MAPS

LIST OF ACRONYMS

ANC	African National Congress
ANDM	Amhara National Democratic Movement
ASPRO/SPAIR	Assessment of Probabilities / Subjective Probabilities Assigned to Investment Risk
BBC	British Broadcasting Corporation
bbl/d	Barrels per day
BOO	Build-Own-Operate
BOT	Build-Operate-Transfer
BOOT	Build-Own-Operate-Transfer
BP	British Petroleum (formerly)
CERA	Cambridge Energy Research Associates
CNOOC	Chinese National Offshore Oil Company
CSO	Civil Society Organisation
EIA	Energy Information Administration
ENDF	Ethiopian National Defence Forces
EPDM	Ethiopian Peoples Democratic Movement
EPRDF	Ethiopian People's Revolutionary Democratic Front
ESDL	Ethiopian Somali Democratic League
FDI	Foreign Direct Investment
FfP	Fund for Peace
GE	General Electric
GDP	Gross Domestic Product
GNP	Gross National Product
HIV/AIDS	Human Immunodeficiency Virus/Acquired Immune Deficiency Syndrome
ICRC	International Committee of the Red Cross
IEA	International Energy Agency
IMF	International Monetary Fund
JV	Joint Venture
LNG	Liquid Natural Gas
MEND	Movement for the Emancipation of the Niger Delta
MLDR	Multilateral Debt Relief Initiative
NGO	Non-Governmental Organisation
NOC	National Oil Company
ONLF	Ogaden National Liberation Front
OPDO	Oromo People's Democratic Organisation
OPEC	Organisation of the Petroleum Exporting Countries

PMC	Private Military Companies
SEPDF	Southern Ethiopia Peoples Democratic Front
SEPDM	Southern Ethiopia Peoples Democratic Movement
SG	Société Generate
SPDP	Somali People’s Democratic Party
TPLF	Tigray People's Liberation Front
UN	United Nations
US	United States of America
USSR	Union of Soviet Socialist Republics
VOA	Voice of America
WSLF	Western Somali Liberation Front
WWII	Second World War
ZPEB	Zhongyuan Petroleum Exploration Bureau

CHAPTER ONE: INTRODUCTION

1.1 General Introduction

Like most industries seeking to maximise profit and minimise cost, the oil and gas industry is not exempt from this dictum. However, this industry is unique in its predicament of both having to supply what ultimately is a finite resource, as well as having the task of fuelling the majority of the world and its people. The oil and gas industry is part of the greater hydrocarbon[1] industry that includes coal and other fossil fuels, which in turn falls under, along with the mining industry, what is collectively known the extraction industry. However, for the purposes of this research study, only the petroleum based oil and gas industry will be examined. This industry is one that continually seeks out new avenues of investment in order to keep up with international and domestic demand, and maintain a level of profit that assures sustainability and continued existence in the market. Ultimately, this translates to investing in new territories, which includes the initial exploration costs to determine proven petroleum reserves, as well as production costs. It is the nature of all business initially to seek out *backyard* investments in low political risk areas. This has generally been the case for the majority of the 20th century for the oil and gas industry, but in recent decades, a number of factors have led to increasing investments in troubled territories.

Over the preceding four decades 'the globalisation trend and ever increasing flow of foreign direct investment [(FDI)] worldwide have integrated the global market place' (Alon et al., 2006, p. 623) seeing investments move further afield. Along with globalisation, a number of continuous factors coupled with fluctuating factors have been identified through research, which has resulted in the oil and gas industry moving beyond these low political risk *backyard* investments to those with increased political risk for investors. Fluctuating factors include events such as the 2007-2009 economic crisis, and the decline of nationalisation in the 1970's, while continuous factors include supply stability, operational capacity, resource depletion, and economic growth. Together these factors create a scenario that has seen exploration and production taking place in higher political risk countries such as Angola and Nigeria, and Ethiopia has been identified as the next possible source of significant petroleum based hydrocarbon reserves in Africa.

According to Alon et al. (2006, pp. 623-4) 'Multinational corporations around the world realize the importance of capturing an early market share, even in locales that may seem risky prospects.' It is here that the added dimension of the discipline political risk is of value to the

[1] Hydrocarbon refers to a compound that contains hydrogen and carbon (Thompson, 1995).

investor. Political risk and the analysis thereof can be used as a lens that brings increased clarity and focus to certain aspects of foreign investments. As Brink (2004, p. 1) states 'The term investment implies an expected return,' however a return is not always guaranteed, and the investor 'runs the risk of not receiving expected returns, making fewer gains on the investment, or losing the investment entirely' (Brink, 2004, p. 1). In this research study, the political risk associated with oil and gas investments in high political risk regions will be examined. The case study will focus on investments made in petroleum, both exploration and production, in the Ogaden Basin region of eastern Ethiopia. Technically this region forms part of the Somali Regional State,[2] but the focal point of this research study will be specifically on the Ogaden region of the State.[3] The name *the Ogaden* is primarily used as a geographical reference for the area lying south of Jijiga Zone, this area incorporates the Ogaden Basin, the term also stands as a genealogical reference for the Somali Ogaadeeni clan lineages (Gebre-Mariam, 2005, p. 12). This region has been selected as the case study (to be conducted in chapter four) because of the increasing interest in the political risk associated with it (like other regions such as Angola and Nigeria). This potential high political risk is not necessarily negative; it could translate to possible 'lucrative future opportunities to more aggressive competitors' (Alon et al., 2006, p. 624) in the oil and gas industry.

1.2 Literature Survey

The literature and data sources covered in this research study, involves three areas, the first and second areas forming the basis of chapter two, while the third area is covered in chapter three. The first area concerns the literature surrounding the conceptualisation of political risk (and the analysis thereof), and will be examined with the aid of Brink's 2004 work, *Measuring Political Risk: Risks to Foreign Investment*. Further, articles by Robock (1971), Freeman and Job (1979), Kobrin (1978, 1979), Micalleff (1981), Fitzpatrick (1983), Simon (1984), Cosset (1991), Frynas (1998), Howell (1998), Vertzberger (1998), Brink (2004), Alon et al. (2006), Hough et al. (2008), and Bremmer and Keat (2009) will be used for their contribution to the field of political risk and the analysis thereof.

The second area of literature covered in this research study focuses on contextualising the conflict in the Ogaden by examining certain publications that have been central in developing an

[2] Ethiopia's eastern Somali state is known by a number of names, administratively it is called *Region 5* (*kilil amist* in Amharic), the *Somali Regional State*, and the *Somali Region* (these terms are often used interchangeably).

[3] The Ogaden Basin and the Ogaden region of the Somali Regional State will be referred to in this research study as *the Ogaden*, some authors and commentators term the region *Ogadenia* or *Ogaden*, and not *the Ogaden*, but for the purposes of this research study (unless quoted), *the Ogaden* will be used throughout.

understanding of this conflict. These publications include the 2008 report by Human Rights Watch,[4] titled *Collective Punishment: War Crimes and Crimes Against Humanity in the Ogaden area of Ethiopia's Somali Regional State*, and the Fund for Peace's[5] (FfP) 2008 Report on Ethiopia. As this section[6] of the research study deals with an overview of, and the background to the conflict, some general information will be used from the *Encyclopaedia Britannica*. This section briefly covers historical developments that have affected the current day conflict, developments that go back almost two millennia. Finally, the social commentary of Garad (2009) will be examined in his recent article in the American Chronicle,[7] as well as Pham's (2007) testimony before the United States (US) House of Representatives,[8] on the *Regional Dimensions of the Human Rights and Humanitarian Situation in the "Ogaden," Somalia and Beyond*.

The third area of the literature and data sources covered in this research study will focus on the practical application of political risk in terms of its use in the oil and gas industry. Here articles and sources from Lax (1983), Wells and Gleason (1995), Knott (1997), Venter (1997) Alon and Martin (1998), Morgan (1998), Hallmark and Whited (2001), Marwick (2001), Boulos (2002), Berlin (2003), Alon et al. (2006), the Economist (2006), Bremmer (2009), Control Risks (2009), and Exclusive Analysis (2009) will be examined. These articles provide insight into defining the relationship between political risk and the global environment as well as the oil and gas industry. Further, they provide insights into the decision-making (risk assessment) and management (risk mitigation) aspects of political risk in the oil and gas industry. A number of these articles cover extensive ground concerning industry specific political risk analysis as well conceptual and definitional frameworks of political risk directly related to the oil and gas industry.

1.3 Research Problem

As mentioned, a number of factors have led to the oil and gas industry seeking out new investments in regions with increased political risk, such as Angola and Nigeria. These countries indicate the potential similarities for the same industry in Ethiopia, specifically regarding the

[4] 'Human Rights Watch is one of the world's leading independent organizations dedicated to defending and protecting human rights' (Human Rights Watch, 2009).

[5] The Fund for Peace (FfP) is 'a research and educational organization that works to prevent war and alleviate the conditions that cause war. [Specialising] on the diagnosis and resolution of conflicts associated with weak and failing states' (Fund for Peace, 2009a).

[6] In this research study a section refers to a main heading in a chapter, designated by the first number representing the chapter and the second the section, for example 1.2 Literature Survey. Sub-sections are headings that fall below section headings, denoted by the first number corresponding to the chapter, the second to the section, and the third and/or fourth referring to the sub-section, for example 2.3.1 Risk or 3.6.3.1 Angola LNG.

[7] 'The American Chronicle (...) and affiliates are online magazines for national, international, state, and local news. [They] also provide opinion and feature articles.' (American Chronicle, 2009).

[8] Committee on Foreign Affairs, Subcommittee on Africa and Global Heath, October 2, 2007 (Pham, 2007)

political risk for investors. Angola, a member of the Organisation of the Petroleum Exporting Countries[9] (OPEC) since January 2007, is currently the largest oil producer on the African continent[10] (OPEC, 2009b). In the last decade, crude oil production in Angola has grown considerably,[11] and this trend is expected to increase as new deep-water production sites come online. According to a report issued by the Energy Information Administration[12] (EIA) in March 2008, Angola is regarded as 'one of the most difficult places in the world to do business as a result of cronyism and bureaucracy; and there are persistent allegations of corruption and lack of transparency in public finance' (EIA, 2009b). Although the Angolan civil war ended in 2002, this outlook remains, and its ranking position on the World Bank's Doing Business[13] list has changed only one position from 2008's 169, to 168 in 2009 (Doing Business, 2009a). Despite this negative outlook from the World Bank, as stated oil production has increased steadily over the last decade, as has the more recent investments into natural gas[14] (EIA, 2009c).

Nigeria, a member of OPEC since 1971, is currently the second largest producer of oil in Africa.[15] In terms of the Doing Business list, it is more favourably ranked when compared to Angola, being situated at 118 (Doing Business, 2009d). However, this does not necessarily mean that the situation and level of political risk for investors has been proportionally that much better than in Angola, if anything the opposite has been observed. The vast majority of Nigeria's oil is located in the southern region of the country in the delta of the Niger River, this region, known as the Niger Delta, has been a source of extensive conflict over the years. Investors in the oil industry in this region have had to constantly deal with local militia groups who, 'seeking a share of the oil wealth often attack the oil infrastructure and staff, forcing companies to declare *force majeure*[16] on oil shipments' (EIA, 2009e). Further, investors continually have to deal with the theft of their

[9] 'The Organization of the Petroleum Exporting Countries (OPEC) is a permanent intergovernmental organization, created at the Baghdad Conference on September 10–14, 1960, by Iran, Iraq, Kuwait, Saudi Arabia and Venezuela. The five Founding Members were later joined by nine other Members: Qatar (1961); Indonesia (1962) -- suspended its membership from January 2009; Socialist Peoples Libyan Arab Jamahiriya (1962); United Arab Emirates (1967); Algeria (1969); Nigeria (1971); Ecuador (1973) -- suspended its membership from December 1992-October 2007; Angola (2007); and Gabon (1975–1994)' (OPEC, 2009a).

[10] As of June 2009, Angola's crude oil production was at 1.802 million barrels per day (bbl/d) (OPEC, 2009b).

[11] Oil production has grown from an average of 710,000 bbl/d in 1997, to an average of almost 1.7 million bbl/d in 2007 (EIA, 2009d).

[12] 'The Energy Information Administration (EIA) provides policy-neutral data, forecasts, and analyses to promote sound policy making, efficient markets, and public understanding regarding energy and its interaction with the economy and the environment' (EIA, 2009a).

[13] 'The Doing Business project, developed by the World Bank, provides objective measures of business regulations and their enforcement across 181 countries' (Doing Business, 2009c).

[14] Chevron, Total and BP have all made investments into natural gas in Angola (EIA, 2009c).

[15] As of June 2009, Nigeria's crude oil production was at 1.746 million bbl/d (OPEC, 2009b).

[16] A *force majeure* is an unforeseeable course of events that result in a company excusing itself from the fulfilment of a contract.

investment, as oil is stolen directly from pipelines, 'commonly referred to as "bunkering", [which] leads to pipeline damage that is often severe, causing loss of production, pollution, and forcing companies to shut-in production' (EIA, 2009e).

Despite the problems associated with the Delta, particularly those related to the Movement for the Emancipation of the Niger Delta[17] (MEND), oil production has continued,[18] this is supported by recent reports from both the EIA and the International Energy Agency[19] (IEA). The EIA (2009f) 'estimates Nigeria's effective oil production capacity to be around 2.7 million [barrels per day] (bbl/d), but as a result of attacks on oil infrastructure' this has never been realised. Further, the conflict in the region has not deterred investors[20] who have continued their operations due to cheap production costs.[21] This is despite MEND seeking 'a redistribution of oil wealth and greater local control of the sector' (EIA, 2009f). The Ogaden promises similar rewards to investors as its counterpart regions in Nigeria and Angola, however as with those countries, it also raises some serious concerns regarding the political risk for investors. In their 2009 report, Doing Business ranked Ethiopia at 116, which is comparable to Nigeria, but this represents an increase of seven positions from its 2008 ranking of 109 (Doing Business, 2009b), raising further questions regarding the political risk for investors in the country, and more specifically in the Ogaden region.

According to Brink (2004, p. 3) 'There is certainly a need for new research and novel approaches to the field of political risk analysis and the managements of such risks' and consequently, this research study will contribute to the field of industry specific political risk analysis by means of a case study. The research topic was derived by first selecting an industry that was of significant relevance to current research in academia. Energy has been and continues to be of prime concern to a number of disciplines, and it was felt that the energy sector warranted closer inspection with regard to political risk and its application. Within the energy sector, the extraction industry was specified, choosing to focus on the extraction of hydrocarbons, specifically oil and gas, including investments in the exploration thereof. In terms of the political

[17] Movement for the Emancipation of the Niger Delta (MEND) are the 'main militant organization attacking oil infrastructure for political objectives' in the Niger Delta region of Nigeria (EIA, 2009f).

[18] Levels of production have seen slow growth year on year since 1990, peaking in 2005 at 2.5 million bbl/d (EIA, 2009b), but there has been a sharp decline since then with the International Energy Agency reporting in June 2009 that levels are now at 1.72 million bbl/d (Lhuillery, 2009).

[19] 'The International Energy Agency (IEA) is an intergovernmental organisation which acts as energy policy advisor to 28 member countries in their effort to ensure reliable, affordable and clean energy for their citizens' (IEA, 2009).

[20] Shell, Chevron, Exxon Mobil, Total, and Eni/Agip are all heavily invested in Nigeria (EIA, 2009f).

[21] 'It still costs under $5 a barrel to pump Nigeria crude, (...) the oil firms will stay' (The Economist, 2003, p. 71).

risk associated with the oil and gas industry, only a few authors have conducted research and thus it was decided that further research was both necessary and warranted.

Africa was selected as the continent of interest, and within Africa the Ogaden region of eastern Ethiopia was chosen as it has recently come to the fore as a possible significant source of petroleum reserves, and consequently issues of ownership of these resources as well as independence for the region have heightened. There have been a number of violent attacks, murders, and kidnappings involving the Ogaden National Liberation Front[22] (ONLF), in their attempts to seek autonomy in the region, and claim ownership of the resources. This raises the question, 'A host government might welcome foreign investment – but do the governed?' (Brink, 2004, p. 2), and forms part of the problem which is under investigation in this research study. The Ethiopian government welcomes foreign investment, but the ethnic Somalis living in the region do not (this will be explored further in chapters two and four of this research study). The Ogaden was chosen over other African regions rich in petroleum reserves because it represents a region that is on the cusp of developing a fully-fledged oil and gas industry, unlike Nigeria and Angola, which already have established oil and gas industries. Further, little academic research has been done on the political risk of this region in relation to the oil and gas industry and thus this research is relevant as considerable investment opportunities still exist. Decisions made regarding these investments opportunities are affected by political risk, and therefore political risk analysis can be used as a component of the decision-making process for potential investors as well as component of the management of these potential political risks.

There is and always has been a relationship between politics and business that affects investment, and understanding that relationship better aids in understanding the political risk involved when investing. By undertaking this research study, the nature and extent of the political risk involved can be determined, and therefore 'risks can actually be exploited and even possibly profited from depending on the degree to which an investor is either risk averse or risk assertive' (Brink, 2004, p. 4). Variables[23] used in political risk models can be based on internal or external events, being either from within the host country where the investment is made (e.g. a coup d'état) or from outside its territorial boundaries (e.g. an invasion by a neighbouring country), 'and can pose macro (generic) and/or micro (specific) risks' (Brink, 2004, p. 1). To a certain degree, an

[22] 'The Ogaden National Liberation Front (ONLF) is a grassroots social and political movement founded in 1984 by the Somali people of Ogaden who could no longer bear the atrocities committed against them by successive Ethiopian regimes. Today, the ONLF as both an advocate for and defender of the people is dedicated to restoring the rights of Somalis in Ogaden to self-determination, peace, development and democracy' (ONLF, 2009).

[23] The term *risk factor* is sometime referred to as a *risk variable*, and not all authors identify the contributing aspects of risk factors or variables as *risk indicators*, choosing to refer to them as *sub-factors* or *sub-variables*. For the purposes of this research study, the terms *factors* and *indicators* will be used, the combination of which will be referred to as *variables*.

industry specific model and the political risk analysis associated with its use can provide a means to recognise and in some case anticipate political risk. This is done through selecting the most reflective factors and their conceptualising indicators, be they internal or external, macro or micro, and understanding the relationship between these factors, which will aid in developing a political risk model specific to the oil and gas industry.

Thus, from the analysis in this section, the main research question to be investigated in this research study is the following:

- What is the level of political risk that the Ogaden region of eastern Ethiopia poses for companies operating in the oil and gas industry?

Two sub-questions have been identified that both supplement and support the main research question, they are as follows:

- What are the factors and indicators that would be included in a political risk model specifically envisaged for the oil and gas industry?
- What is the practical application of political risk as a decision-making (risk assessment) and management (risk mitigation) tool for investors?

1.4 Objectives and Relevance of the Research Study

One of the areas of concern for this research study will be to focus on the underlying theory of political risk, which is centred on a combination of problem solving theory and decision theory (Brink, 2004, p. 30). 'One way of solving the problem of not knowing what is "out there," is by knowing what is' (Brink, 2004, p. 3). With threats being observed and measured, political risk analysts can manage these threats; and being able to recognise and anticipate them plan for reoccurrences in the future (Brink, 2004, p. 3). More often than not, it is uncertainty that has kept investors from investing in Africa, not risk. Identifying what the risks are associated within a specific industry in a particular territory goes some way to eliminating this uncertainty, as threats can be observed and measured. The main objective of this research study is to provide an in-depth analysis of the political risk attributed to the oil and gas industry in the Ogaden. The purpose of this research study is therefore to understand the relationship between the extraction of resources from a region and the political risk of that region. In doing so, an industry specific political risk model will be developed that can be used by political risk analysts as a decision-making tool.

Additionally, the research aims to determine if investors simply use political risk and the analysis thereof as part of the decision-making process, or additionally as a means to manage the situation *on the ground* with a greater understanding of the risks involved. According to some

researchers, despite the availability of political risk analysis for investors in the oil and gas industry, when it comes to lucrative investments in oil and gas, companies are prepared to conduct business with almost any country (Alon et al., 2006, p. 631). Further, in developing a political risk model specific to the oil and gas industry, the model should always be 'adaptable and flexible so that [it] can be reconstructed to suit industry and investor specific micro circumstances' (Brink, 2004, p. 3). Therefore, the model that will be developed in chapter three will be done so with this principle in mind. According to Brink (2004, p. 3), 'There is a need to fill the gap in contemporary political risk analysis research with a model that better represents reality,' and thus this research study is of relevance with the industry specific political risk model that will be developed in chapter three, aiming to do just that.

1.5 Research Design and Research Methods

The research design is of an empirical nature, requiring analysis of existing data, in order to answer the causal, predictive, and historical questions regarding the relationship between political risk and the oil and gas industry. This is a qualitative secondary data research study, which will rely on existing data relevant to the research question, sourcing information from academic books and journals found in the University of Stellenbosch library, as well a number of journals, articles, and other sources available on the internet. This research study is micro in its scope, focusing only on the oil and gas industry, both exploration and production, within the broader extraction industry, as well as focusing on a particular region, that of the Ogaden, which serves as the case study for this research.

Secondary data will be used in the findings of chapter two, three, and four. In chapter two, secondary data will be used to look at the underlying theoretical perspective of political risk, and further to contextualise the research study by providing an overview of the conflict in the Ogaden. This will establish a background for the research, one based in theory and one based historical accounts, which will aid in the development of the industry specific political risk model in chapter three, and its application in chapter four. Chapter three will look at the existing literature on the political risk associated with the oil and gas industry, including the literature surrounding the use of political risk analysis by investors as a decision-making and management tool, both *ex ante*[24] and *ex post*[25] an investment.

[24] *Ex ante* is the Latin term meaning *from before*, this term will be used throughout this research study to refer to political risk done as part of the decision-making/risk assessment process.

[25] *Ex post* is the Latin term meaning *from after*, this term will be used throughout this research study to refer to political risk done as part of the management/risk mitigation process.

The purpose of this research study is as an explorative, descriptive, and explanatory analysis of the political risk associated with the oil and gas industry in the Ogaden. The research study is explorative in that it aims to provide a basic familiarity with the topic (Babbie & Mouton, 2005, p. 79), focusing on a relatively new case study, in terms of the political risk the oil and gas industry faces in the Ogaden. It is descriptive in that the research study aims to describe the situation and events including a conceptual and historical analysis (Babbie & Mouton, 2005, p. 80). Finally, this research study is explanatory in that it aims to explain the causal relationship between the events (Babbie & Mouton, 2005, p. 81) in the Ogaden and the investments made in the region by foreign or multinational oil and gas companies. The unit of analysis in this research study is the industry specific political risk models and the level of analysis will be micro in scope, focusing on a specific industry (the oil and gas industry) in a specific region (the Ogaden).

1.6 Limitations and Delimitations of the Research Study

One of the limitations to this research study concerns the investigation of political risk models used by the political risk analysis industry, either specific or general, for determining the political risk investments and investors face in the oil and gas industry. The existing models, along with the factors and indicators that comprise them, are not readily available as they are considered an intellectual property right of those companies who have developed them. What is known of these models has been reconstructed (or reverse engineered) by authors who have examined the actions taken by the companies that use political risk models in order to determine characteristics and elements of them. Although this has aided in the study of industry specific political risk models, this type of reconstruction is an incomplete picture of the actual models used.

Further to the limitation above are the problems associated with the discipline of political risk itself. According to Alon et al. (2006, p. 624), 'if there is one agreement in the literature, it is that a consensus has not been reached regarding the definition of the term.' As well as problems associated with defining the term, Brink (2004, p. 2) adds that 'The measurement and observation of political risk depends to a great extent on subjective human judgment which is in some instances a handicap for political risk analysis.' It is for this reason that the use of a political risk model for analysis is essential to *balance* out the subjectivity of the user, and thus provides a more objective probable estimation of risk that reflects researched information (Brink, 2004, p. 2). The underlying theory of political risk will be expanded and explored in chapter two, and these limitations will be dealt with in detail there.

The time span specific to the case study in chapter four will be from 1995, when the insurgency by the ONFL began, to recent years, as late as October 2009, when work was published

on the topic. For the purposes of the background to the conflict in the Ogaden examined in chapter two, the period will extend further back in order to get a more complete picture, however brief, of the conflict in the region. Further justification for this micro-focused research is the time and costs involved, both of which limit the scope of the research study. Although a full industry specific political risk model for the oil and gas industry will be developed, the aspects of the model that pertain to a political risk analysis without knowledge of the investor will be presented in greater detail. The aspects of a political risk model that has knowledge of the investor will be presented, but in lesser detail, as the political risk analysis conducted in chapter four will be done so without knowledge of the investor. This is also due to the limitations associated with time, and more significantly the length requirements of this research study.

As stated early in this chapter,[26] this study will use secondary data sources, and as stated above, not having access to actual political risk models used due to intellectual property rights is a limitation to this research. Access to primary data may have enhanced this research study and its findings. However, for the reasons mentioned here and above, this has not been possible, and therefore the focus has been on the available secondary data.

1.7 Outline of the Remainder of the Research Study

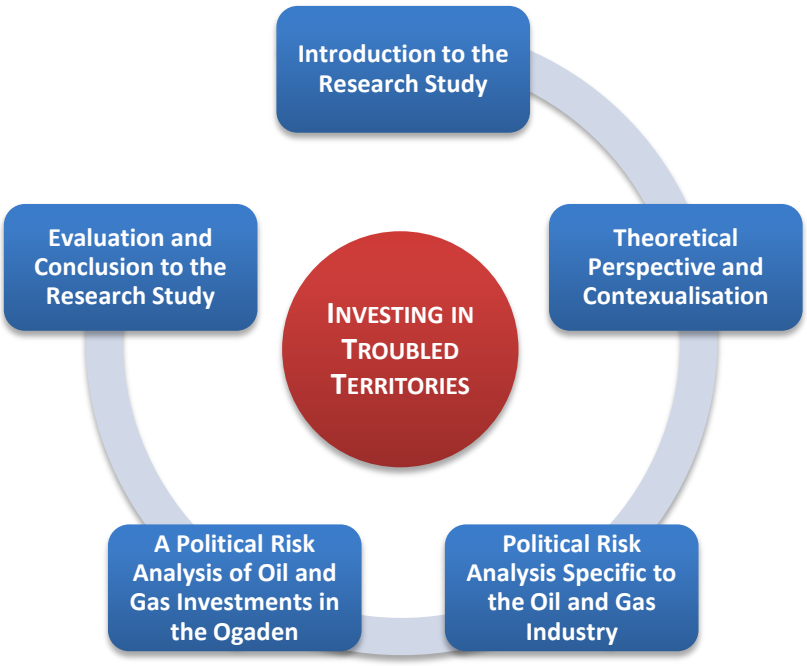


Figure 1: Outline of the Remainder of the Research Study

Figure 1 shows the course this research study will take through the five chapters described in this section. The focus of this first chapter has been on introducing the research study with a general

[26] See section 1.5 Research Design and Research Methods

introduction followed by a brief literature survey. The research problem discussed the genesis of the research study and its formulation, while the research objective was recognised as an attempt to clarify the political risk associated with the extraction of resources from a particular country or region (in this research study, the Ogaden). The main research question and two sub-questions were identified, and the research design and data gathering methods were outlined. Finally, the limitations and delimitations of the research were presented.

Chapter two focuses on the underlying theory of political risk and conceptualises key terms central to political risk, beginning by briefly looking at decision-making and problem solving theory. The research study will be contextualised by looking at the history of the conflict in the Ogaden from the Ethiopian government, Somali, and ONLF perspectives, taking into consideration the recent discovery of oil and gas in the region. By undertaking this examination of the theoretical perspective, looking at key concepts, as well as the history of the conflict, looking at key stakeholders, a foundation is established to which the industry specific political risk model can be developed in chapter three, and to which the case study can be applied in chapter four.

Chapter three will focus on political risk analysis specific to the oil and gas industry. Here political risk will be reviewed in terms of its relationship with the global environment and oil and gas industry. The factors and indicators relevant to this industry will be discussed based on an examination of the IHS[27] model, the sources of political risk faced by the extraction industry as defined by Control Risks,[28] and factors and indicators relevant to the oil and gas industry as suggested by Alon et al. (2006), Berlin (2003) and Lax (1983). Further, this chapter will focus on the methodology of building a political risk model for the oil and gas industry, and analyse the simplified political risk model developed by Alon et al. (2006) for industry specific adaptation. This analysis forms the basis for the political risk model specific to the oil and gas industry developed in this research study. Chapter three will conclude by examining political risk in terms of its role as a decision-making (risk assessment) and management (risk mitigation) tool for the investor, with aid of relevant examples of both.

In chapter four, a political risk assessment will be presented of the Ogaden, in relation to the potential for oil and gas investment in that region. Here the focus will be on applying the political risk model specific to the oil and gas industry developed in chapter three to the case study. The analysis will begin with a look at the geographical region under investigation and the

[27] 'IHS is a leading global source of critical information and insight, (...) product and service solutions span four areas of information that encompass the most important concerns facing global business today: Energy, Product Lifecycle, Security and Environment' (IHS, 2009).

[28] 'Control Risks is an independent, specialist risk consultancy who provide advice and services relating to strategic management and operational risks' (Control Risks, 2009b).

status of the oil and gas industry in that region, followed by a political risk analysis using the relevant factors and indicators. These indicators will be scored in terms of the political risk model developed in chapter three. The total score will be evaluated using the *scale for investment and political risk indication*, and the *phase one guidelines* (for *security, investment, political and economic situations*) for analysts and investors, both discussed in chapter three. The chapter will conclude with a brief look at the recommendations to investors in terms of risk management.

Chapter five will conclude the study with an overview of the research undertaken in chapters two, three, and four in context of the research question and the aims and objectives of the study. This chapter will also focus on the relevance of political risk analysis, and the need for further research in certain areas of the field. The study will conclude with an evaluation of the research undertaken and a final analysis of the oil and gas industry in eastern Ethiopia in terms of its increasing political risk to foreign investors.

1.8 Conclusion

This chapter serves as both a general introduction to the study, as well as technical outline of the research, its objectives, limitations and delimitations, methodology, and what is to follow in the remaining chapters. The central research question of this study concerns the level of political risk that the Ogaden region of eastern Ethiopia poses for companies operating in the oil and gas industry. The aim of the research study is to answer the main research question, as well as the two sub-questions that both supplement and support the main research question. The sub-questions concern issues pertaining to the factors and indicators that would be included in a political risk model specifically envisaged for the oil and gas industry, and further, the practical application of political risk as a decision-making and management tool for investors.

The following chapter will provide the theoretical perspective for the research study by conceptualising key aspects of political risk. Secondly, it will contextualise the research study by looking at the history of the conflict in the Ogaden. The aim of the chapter will be to provide a clearly defined point of departure and to conceptualise the most important features of political risk, before commencing with the building of a political risk model specific to the oil and gas industry in chapter three. Further, it will provide a concise look at the history of the conflict in the Ogaden, before the practical application of the industry specific political risk model to the region in chapter four. Thus, the chapter provides both the foundation and the framework for the remainder of the research study.

CHAPTER TWO: THEORETICAL PERSPECTIVE AND CONTEXTUALISATION

2.1 Introduction

The investor is often faced with certain *unknowns* when it comes to an investment, whether new or existing. As Hough et al. (2008, p. 6) argue, these *unknowns* are largely due to the fact that 'political systems and countries do not carry warning labels' concerning possible problems when it comes to certain aspects pertaining to an investment. Thus, there is a demand for a means to examine and explain these *unknowns*, and this demand is supplied through the field of risk analysis, which includes country and political risk analysis (Hough et al., 2008, p. 6). Although related, it is important to distinguish between country risk and political risk, and this distinction will be discussed in this chapter. The purpose of this research study is to focus on political risk and the analysis thereof, and not country risk.

'Risk analysis is an ancient craft that has been practised by merchants and traders (as well as decision makers in the political and military fields) over centuries' (Hough et al., 2008, p. 6). It became a popular field of study during the mid-1970s in the aftermath of the 1973-1974[29] oil crisis, which made investors aware of the importance of undertaking some sort of analysis concerning political risk for their existing operations, as well as future investments (Brink, 2004, p. 3). During the Cold War,[30] risk analysis became relevant as a scientific means to aid in decision-making, gaining momentum after the 1973-1974 oil crisis and reaching an apex in the 1980's. In the decade following the end of the Cold War, it seemed that the relevance of political risk was in decline. This was not only the result of inaccurate forecasts by analysts, but also a too narrow conceptualisation of political risk that did not keep up with how globalisation was changing economic environments at the time (Hawkins, 1996, p. 6). However, in a post 9/11[31] world, 'increased uncertainty and the salience of non-traditional business and societal risk such as terrorism, corruption, climate change and global warming (...) have not only increased the awareness of risk in a complex environment, but have also increased the demand for risk analysis' (Hough et al., 2008, p. 6).

The following chapter has a dual purpose, firstly it will provide a theoretical perspective to the research study by conceptualising key aspects of political risk, and secondly it will contextualise the research study by looking at the history of the conflict in the Ogaden. Since the

[29] The 1973-1974 oil crisis refers to the embargo from October 1973 till March 1974 imposed by OPEC on the US and other states, particularly Western countries, specifically those that supported the US Middle East policy and Israel during the Yom Kippur war.

[30] The Cold War refers to the period that followed WWII until the fall of the Berlin wall in 1989 and the demise of the Union of Soviet Socialist Republics (USSR) in 1991. The period was marked by the ideological differences between capitalism and communist socialism, spearhead by the US and the USSR respectively.

[31] 9/11 refers to the terrorist attacks on the World Trade Centre in New York City on 11 September 2001.

1973-1974 oil crisis, many scholars have undertaken an examination of political risk from a number of differing perspectives. Consequently, there are varying viewpoints and conceptualisations regarding what political risk and the analysis thereof entails. As addressed in chapter one,[32] and argued for by Alon et al. (2006, p. 624) and Brink (2004, p. 2), these differing perspectives have left little agreement on a clear and concise definition of the term *political risk,* which is always hampered by its subjective measurement and observation. To this end, the aim of this chapter is to provide a clearly defined point of departure and to conceptualise the most important aspects of political risk. This will provide the framework on which a political risk model specific to the oil and gas industry can be developed in chapter three, and the practical application of that model to the case study in chapter four. Figure 2 provides an overview of this chapter, which is divided into the two main sections discussed above; further, it shows the foundational connection between decision-making and problem solving, and political risk, and the link to chapter three.

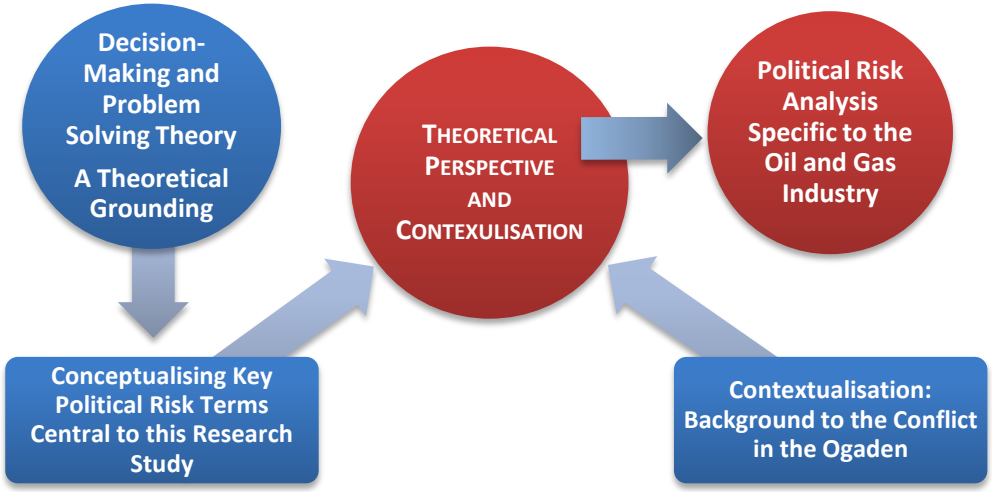


Figure 2: Theoretical Perspective and Contextualisation

2.2 Decision-Making and Problem Solving Theory - A Theoretical Grounding

The standard theory of problem solving, initially outlined by Newell et al. (1958), focuses on how humans respond when they are confronted with unfamiliar tasks. According to Simon (1986) 'the work that steers the course of society and its economic and governmental organizations, is largely the work of making decisions and solving problems.' He argues that decision-making and problem solving revolve around 'choosing issues that require attention, setting goals, finding or designing suitable courses of action, and evaluating and choosing among alternative actions' (Simon H. A., 1986). Problem solving usually refers to fixing agendas, setting goals, and designing actions, while decision-making refers to evaluating and choosing. In order for decision-making and problem

[32] See section 1.6 Limitations and Delimitations of the Research Study

solving to be successful, they need to be performed effectively and according to Sickafus (2006), the 'Communication of problem solving is orderly,' it follows the path of definition, through to analysis, through to the solution.

Political risk analysis, in its attempt to manage the uncertainties of investments for the investor, can be seen as 'a rational attempt at problem solving' (Brink, 2004, p. 30). According to Bunge (1998; in Brink, 2004, p. 30), 'rational agents behave as risk-adverse persons intent on minimising uncertainty with the help of expert knowledge.' Political risk analysis examines externally the environment and internally the individuals' understanding of reality, in order to understand and assist in solving problems that the investor faces. There are four steps involved in decision analysis; 'defining the decision statement amongst uncertainty, establishing and evaluating objectives, generating alternatives, and (...) comparing and choosing among other options' (Altier, 1999; Jennings and Wattman, 1998; in Brink, 2004, p. 30). It follows that to minimise the uncertainty the investor must have extensive knowledge of the investment itself, including issues surrounding feasibility; how it would be implemented and operated (Chicken 1986; in Brink, 2004, p. 30).

2.3 Conceptualising Key Political Risk Terms Central to the Research Study

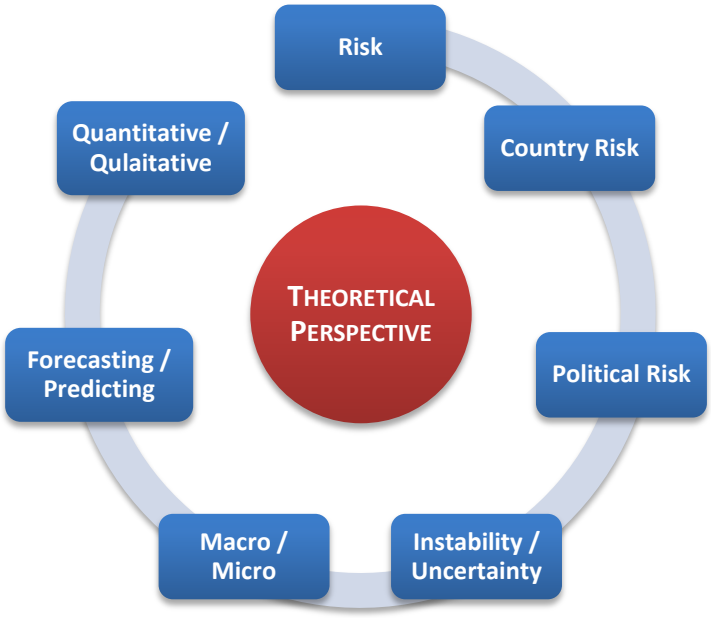


Figure 3: Conceptualising Key Terms Central to this Research Study

Figure 3 illustrates the course that this section will follow, beginning with the concept of risk and concluding with the quantitative and qualitative issues of political risk. Regarding the underlying theoretical perspective of political risk and the analysis thereof, this section will examine key concepts in order achieve a higher level of understanding of this discipline, beginning with the

concept of risk itself. These concepts will also aid in the development in chapter three of an industry specific political risk model for the oil and gas industry. Given the difficulties associated with defining political risk, the conceptualisations of a number of authors will be examined before arriving at a definition, which will be used for the remainder of this research study. The sub-section on political risk and country risk further aids in understanding political risk by examining the intricate relationship between these two concepts. Similarly, the sub-section on political instability and uncertainty will expand on the understanding of political risk analysis by differentiating between these concepts.

Some attention is given to the difference between macro and micro risk, providing the understanding that the political risk analysis that will be undertaken in chapter four will be micro in its scope (although broad macro factors will be included). In the sub-section on forecasting and predicting political risk, understanding political risk is further enhanced with an examination of the limitations and objectives contained within the field. The methodological problems encountered with quantitative and qualitative social science research will be addressed and the effects these problems have within political risk analysis (specifically in developing a model, as will be undertaken in chapter three) will be examined. This will provide an insight into how a political risk analysis is undertaken, showing the route that this research study will take when the political risk analysis is undertaken of the case study in chapter four.

2.3.1 Risk

In the broader sense of the word, risk means that there is a potential or possibility of danger, loss, injury, or other adverse consequences occurring to someone or something (Thompson, 1995). Words that are commonly associated with risk include; vulnerability, danger, misfortune, adversary, hazard, peril, loss, threat, and these words are commonly used in reference to uncertain situations. This uncertainty can result in both positive and negative outcomes, and this neutral concept needs to be understood in terms of the potential for both to occur. According to Vertzberger (1998, p. 22), in terms of decision-making theory, risk is defined as 'the likelihood that validly predictable direct and indirect consequences with potential adverse values will materialise, arising from particular events, self behaviour, environmental constraints, or the reaction of a third party.' With regard to Vertzberger's (1998) definition and in terms of political risk analysis, 'risk has indeterminate outcomes that have not yet occurred (...) [and thus] it constitutes a probabilist assessment [or forecast] and not a precise prediction' (Hough et al., 2008, p. 10). Political risk can therefore be seen as a related concept to risk, being the analytical

process that uses particular variables to forecast the probability of events that may or may not affect an investment.

2.3.2 Country Risk

Within the study and field of risk, there exists a debate amongst academics and practitioners as to what exactly the attributes of country risk and political risk are. This debate is ongoing with scholars disagreeing over the distinctions and definitions of these two terms, and their relation to each other. Brink (2004) argues it is best to view country risk as a specialised cousin of political risk, where the best analytical results occur when the two are used together. Brink (2004, p. 19) elaborates further by differentiating between country risk and political risk in 'the sense that country risk can be explained as potential financial losses due to problems arising from macroeconomic events in a country.' Cosset (1991, p. 135) aids in this description by saying that a 'country risk rating is an indicator of the likelihood that a sovereign borrower will default on its debts.' Country risk can be measured with balance of payment sheets, country credit worthiness, and data on debt servicing ratios, as well as other financial indicators (Brink, 2004, p. 19). Thus, political risk should not be confused with country risk, but rather seen in terms of this specialised cousin relationship, where country risk can be regarded as a factor used when assessing the political risk of a country or region. Hough et al. (2008) identifies the distinction between the political nature of political risk and the non-political nature of country risk. However, they contend that this distinction is problematic 'in the sense that both concepts are eventually defined in both exclusive and narrow terms and in inclusive but overlapping broader terms' (Hough et al., 2008, p. 18).

The primary concern of country risk has to do with finances, in terms of 'countries petitioning for loans, and those (private) banks, states or monetary organisations that are willing to grant those loans' (Brink, 2004, p. 22). This translates to the risk a financial institution runs by giving out such a loan, since the possible inability to service the loan will result in losses for that institution, thus country risk therefore relies greatly on the balance of payments sheet of a specific country. On many occasions where fluctuations in balance sheets occur, these are in effect symptoms of a broader political problem, and when a political risk analysis is conducted, this is identifiable. As Brink (2004, p. 22) argues, country risk is derived from 'inappropriate politics and economic policies that devastate the domestic economy and lead to balance of payment crises or political upheaval.'

Country risk can further be divided into sovereign and transfer risk which form part of a country risk factor that can be used to determine political risk. By extension, countries like

Switzerland, and Australia are considered credit worthy, since they have both a low country risk and a low political risk; they have excellent financial conduct when it comes to their record on repayment of loans. On the other end of the spectrum, countries like Zimbabwe and Côte d'Ivoire, which have both a high country risk and a high political risk, are less likely to receive loans as they have a history of poor repayment of such loans and therefore have problems with their creditworthiness. Thus the distinction between the two terms can be further understood as country risk being a 'country's inability to repay loans, whilst political risk relates to a country's unwillingness to do so' (Brink, 2004, p. 23). Although the relationship between country risk and political risk is not necessarily one that is directly connected, it is possible to have a state with a high country risk, such as Argentina, with a moderate political risk. Alternatively, in the case of India, have a state with a high political risk, but a moderate to low country risk. As Brink (2004, p. 23) argues 'Levels of political risk in a country are not necessarily pegged to levels of country risk and vice versa.' Furthermore, occurrences of political risk may be either short term or 'prolonged and chronically symptomatic of a specific country' (Brink, 2004, p. 23).

The emphasis on the political holds less weight as a factor in a country risk analysis than it does in a political risk analysis. Political risk can therefore be seen as a factor of country risk, whereas economic indicators form part of a factor of analysis undertaken in political risk, which may also include political and societal factors and their indicators. As Robock (1971, p. 8) points out, there is often a blurred line between economic and political indictors and a tendency to over politicise data, he argues that 'Although government decisions are always political - by definition - the forces dictating these decisions might be purely economic.' In summary, it can be argued that country risk is inextricably linked to issues of finance regarding a country's balance of payments and that instances of country risk occur when a country is unwilling or unable to service its debt and make repayments. Whether or not a country is unwilling or unable to service its debts is important, as it can become an issue of political risk. Thus, to conclude this sub-section on the distinction between country risk and political risk, it can be said that 'Country risk differs from political risk in the sense that country risk can be explained as potential financial losses due to the problems arising from *macro-economic* events in a country that are uncontrollable yet often inevitable. Political risk, on the other hand, recognized as factors caused by government policy (in)action or reaction, can to some extent be managed if not avoided' (Brink, 2004, p. 175). As it is not the purpose of this analysis to provide new insight on the distinction between country risk and political risk, this viewpoint will be followed.

2.3.3 Political Risk

Political risk is the study concerned with the risks associated with an investor and/or an investment, in terms of the influence of political sphere. The practical application of the study of political risk is termed political risk analysis, which is the examination of the data identified that may indicate a potential risk the investor or investment faces. Political risk analysis requires updated knowledge of a number of areas which contribute to the analysis of a particular country, these include a combination of, or all of the following variables; politics, history, culture, law, economics, and international relations. However, academics and practitioners differ to varying degrees on exactly which variables should be included or omitted, and this disagreement has resulted in different directions and ideas as to what political risk analysis is. When conducting a political risk analysis, it is essential to the discipline that the correct and relevant variables be selected, if not the analysis will not be accurate. Thus the variables chosen need to contribute to the validity and reliability of the analysis, making the final assessment well grounded, sound, defensible and consistent in quality. These variables can be selected from a vast pool that may or may not have an impact on the political risk associated to a specific venture.

Hard factors[33] may include the following: failed states; states of emergency; political instability; the erosion of support for government and government consent; external, internal or border disputes; military mutiny; fiscal or monetary decisions overwhelmingly influenced by ideology; foreign policy and international relations; and leadership succession issues. While *soft factors*[34] that may contribute to the presence of political risk could include the following: low levels of adult literacy; uneducated or unemployed politically mobile workers; and the depletion of scarce resources. The Human Immunodeficiency Virus/Acquired Immune Deficiency Syndrome (HIV/AIDS) cannot be ignored as a possible economic or political threat to a specific country (Brink, 2004, p. 25). It is also important to remember that not only is there the possibility that the host country poses some kind of risk, risk also extends to the type of investor and the nature of the investment. As Alon et al. (2006, p. 626) identifies, 'the nature and scope of political risk changes with respect to the specific time, home and host countries, and organisations involved.'

Robock (1971, p. 7) identifies four criteria for arriving at an operational definition of political risk; firstly a discontinuity has to occur in the business environment, which is, secondly, difficult to anticipate, thirdly, this discontinuity is as a result of political change and that, fourthly, has the potential for significantly affecting profit or other goals of the firm. Thus, Robock (1971) situates political risk in terms of these difficult to anticipate discontinuous political events and he further

[33] *Hard factors* refer to those events that are clearly and observably a risk to the investor.

[34] *Soft factors* refer to those events that could potentially be a risk to the investor, but are not clear and observable risks.

accounts for a degree of unpredictability. Kobrin (1979, p. 77) argues that the field of political risk concerns 'the probability that changes in the political environment will reduce returns to the point where the project would be no longer acceptable on the basis of *ex ante* criteria.' Kobrin (1979) qualifies his conceptualisation further by distinguishing between changes that affect returns directly and those that affect returns indirectly. Simon (1984, p. 134) argues that the nature of political risk is mostly made up of 'non-economic factors [that] can affect the foreign investment climate in a particular country.' Where Simon's (1984) definition is lacking is in its oversimplification of political risk, further it does not account for a degree of uncertainty or unpredictability, something Kobrin's (1979) definition also lacks. Simon's (1984) definition also focuses on the non-economic dimension of political risk in relation to possible effects to foreign investments, choosing not to focus on issues surrounding the probability of political risk occurring.

Micalleff (1981, p. 48) describes political risk assessment as the 'the systematic means of assessing and managing the political risk of [FDI] or international business.' Micalleff's (1981) definition has tautological problems, as it fails to provide an adequate understanding of the term political risk, with a definition that is again an oversimplification and is thus limited in its scope of the finer details of field. Howell (1998, pp. 3-4) describes political risk as the 'decisions or events of a political nature, whether the result of direct or indirect government action or inaction, or the result of non-government political events and forces.' Howell's (1998) definition is lacking in that it excludes the element of the investment or investors who assume the risk. Investment issues are addressed by Simon (1984, p. 134) who argues that 'one of the main functions of political risk assessment is to determine when and how non-economic factors can affect the foreign investment climate in a particular country.'

According to Fitzpatrick (1983, p. 249), 'a consensus on the precise meaning of the term [political risk] has not yet been achieved' and those definitions out there are 'wide ranging between the general (…) and the specific.' The general definitions can be somewhat vague, such as 'political risks are all "non-business" risks such as creeping expropriation' (Fitzpatrick, 1983, p. 249). While the specific definitions like those used by the Commission on Foreign Investments (International Bank, 1963) for its survey of international business firms, where political risk was described 'in terms of loss of control over ownership or loss of benefits of enterprise by government action' (Fitzpatrick, 1983, p. 249), can be regarded as too narrow.

Brink (2004, p. 25) generally describes political risk analysis as 'the process in which investment potential is measured against the backdrop of certain factors which contribute to levels of political risk in a country.' Analysis by definition implies an interpretation of an event in

terms of its effects with the aid of 'historic, current as well as future investigation' (Brink, 2004, p. 25). Once a model is constructed with the selected factors and their specific indicators (which are used to conceptualise each factor), the process of political risk analysis involves applying that model to a specific country or region, in terms of this research study, the oil and gas industry in the Ogaden. This results in a conclusion of the probability of the political risk in that region or country, in terms of foreign investment. Brink's (2004, p. 25) full definition of political risk analysis is as follows:

> *'[Political risk analysis is] the examination and explanation of the probability that interrelated factors caused or influenced by government political decisions, (in)actions, reactions, or other unforeseen external or internal events will affect business and investment climates in such a way, that investors will lose money or not make as much money as they expected when the initial decision to invest was made.'*

Of the authors examined above, Brink's (2004) definition is the most all encompassing, as it clearly deals with all the key terms required for a precise and concise definition of political risk. However, this definition lacks a dimension that concerns the use of political risk as a decision-making and/or management tool for the investor.

Consequently, the definition of political risk analysis that will form the basis of this research study, which includes the decision-making and management aspects of political risk which are missing from Brink's (2004) definition, is as follows: *Political risk analysis is an adaptable decision-making and management tool, used to gauge and manage current and future probable and potential threats, particularly those regarding financial loss to investors, prospective and/or established, from decisions taken by those in control of a country or region, regardless of whether these decisions are internal or external, actionary or reactionary, the analysis of which is derived from relevant factors (political, economic, and societal) relating to the investor's specific industry*. The inclusion of knowledge pertaining to the investor and the investment is essential for a complete political risk analysis, which can then be used as a decision-making tool, as well as a means to manage the political risk associated with the investment. From the above definitions and analysis, it is clear that the focus of political risk is on *change* within the political environment and that the study or analysis of such changes constitutes the cornerstone of the discipline. As Howell (1998, p. 3) states, political risk is 'the possibility that political decisions or events in a country will affect the business climate in such a way that investors will lose money or not make as much money as they expected when the investment was made.'

2.3.4 Political Instability / Uncertainty

There is often some confusion between political risk and political instability or political uncertainty. Political risk is misunderstood as either political instability and/or political uncertainty, when political instability and political uncertainty are in reality elements of political risk. Brink (2004, p. 19) refers to political instability as a 'biased uncertainty about the probability of political events taking place,' while Robock (1971, p. 8) refers to this concept as a separate though related phenomenon from that of political risk. Similarly, political uncertainty can be said to arise because of inadequate information and therefore can be negated (although not entirely) by increasing the amount of information at hand. Whereas, political instability is a property of the environment, referring to 'unexpected or unforeseen changes in leadership succession, government policy, or in a government's implementation of power' (Brink, 2004, p. 19), thus it can be considered like country risk, as a factor that could point toward the probability of political risk occurring. Political risk on the other hand is a property of business and is 'rather a more objective measurement of the amount of doubt [which is] in contrast to the more subjective nature of instability and uncertainty' (Brink, 2004, p. 19).

Political instability is not only a 'political risk factor that can contribute to losses incurred by foreign investments, such losses can also be a result of host governments nationalisation and confiscation actions, the repudiation of contracts or even a loss of mineral rights for investors in the extraction industry of a host country' (Brink, 2004, p. 19). However political instability and uncertainty do not always have to be considered negative contributing factors to political risk, they can also be seen in a positive way. If an investor takes chances in a positive and profitable environment they may be rewarded for taking such chances when the consequences of making that choice were uncertain, that is part of the risk. As Brink (2004, p. 21) argues, 'if these uncertainties are managed accordingly, the possibility of being able to exploit them becomes a reality.'

Kobrin (1978, p. 114) argues that political instability is a 'separate although related phenomenon from that of political risk.' He states that 'political instability is clearly a property of the environment, while [political] risk is a property of the firm' and that 'the manager should be interested in the political instability only to the extent that it is likely to constrain actual or potential operations' (Kobrin, 1978, p. 114). As examples of this Kobrin (1978, p. 114) cites the 1959 Cuban Revolution and the instability in Argentina during the late 1960s and the early 1970s, where he argues that 'Irregular political change may affect foreign firms adversely.' These irregular changes might also improve the business climate, as was the case when the Peronist regime was overthrown in Argentina, or in Indonesia after the demise of Sukarno, there was a

shift in policy taken towards foreign investment (Kobrin, 1978, p. 114). Frynas (1998) takes this understanding one step further by arguing that political instability is a tangible thing whereas political risk is not, in the sense that instability affects tangible goods such as buildings and licenses, political instability in the form of a riot or a new law may cause serious harm to a company's property. Consequently, political risk is not tangible, but rather a set of expectations concerning potential future political instability. Thus, political risk is a subjective perception of how political instability may affect the firm (Frynas, 1998, p. 458).

Examples of political instability could include an unexpected leadership changes which may have resulted from a coup d'état, or environmental factors such as a high level of HIV/AIDS. Although political risk and political instability are separate but nonetheless related variables, political risk is not necessarily a consequence of political instability and vice versa. What can be said is that political instability points towards the probability of political risk occurring (Brink, 2004, p. 19). The resulting political risk from political instability is the possibility that unexpected government action might create limitations to the business operations of foreign enterprises. Returning to the example of leadership change, although instances of political instability may result in political risk, this is not always the case. Fitzpatrick (1983, p. 250) argues that although there were 40 changes of government in Italy from 1947 to 1983, the political risk associated with investments by foreign entities during that time was negligible. Political instability as a risk factor and property of the environment will not necessarily convert into political risk for a particular investor. For example, if the operation of an investment, such as oil and gas exploration or production requires the use of highly skilled *expat*[35] labour (like the operations in the Niger Delta), the perceived political instability created by HIV/AIDS, which is an attribute of the environment, may not result in a political risk for the investors.

Robock (1971) questions the extent to which political instability can be seen as a reliable index of political risk through a study undertaken by the National Industrial Conference Board on the twelve major capital-exporting nations.[36] This study concluded that many investors decline investment opportunities based on a misguided perception of political instability, which is largely because of a lack of knowledge by the foreign and often distant investor. 'There is evidence (...) that political differences that would pass at home as "natural discord" become "disturbing imbalances" when viewed by investors in a distant country' (Robock, 1971, p. 15). Kobrin (1978, p. 120) agrees with this view when he argues that to a great extent political instability is a culturally

[35] The term *expat* refers to expatriate workers, those foreign workers that live and work abroad, usually for long periods.

[36] Belgium, Canada, Denmark, France, Germany, Italy, Japan, The Netherlands, Sweden, Switzerland, the United Kingdom and the United States.

specific phenomenon, adding that 'Events are only irregular and destabilising to the extent that they violate established role expectations in a given political system.' It is sometimes difficult to evaluate whether an irregular political event poses a political risk, and this is because of the innate human tendency towards ethnocentrism. The deposing of South African National President Thabo Mbeki by rival and newly elected African National Congress (ANC) President Jacob Zuma in 2008 is an example of the political struggles that take place within a country. An event such as this should not immediately be converted or transformed into the existence of political instability. Thus, it could be argued as Robock (1971, p. 15) does, that the criteria for political instability are different in every political setting, and frequent change in government is a highly flawed indicator of political risk.

Some authors would argue that political instability can result in opportunities for investors regardless of whether there is resulting political risk or not. Frynas (1998) argues that political instability may provide an opportunity for investment and thus may assist companies in reaching their corporate goals under certain circumstances. A clear example of an industry that would benefit from political instability would be Private Military Companies (PMCs), which are called in when political instability threatens an investment or those *expats* employed by the investors. Frynas (1998, p. 460) uses the example of the oil production operations of Royal Dutch Shell in the Niger Delta, where he argues that political instability has had little effect on the profitability of the investments made by that company in Nigeria, although those investments face constant political risk. There is certainly evidence to suggest that production is not at full capacity, and there has been a decline in capacity,[37] however this does not influence already sunk costs of production, or the cheap production costs of Nigerian crude,[38] it simply means profits are diminished.

2.3.5 Macro and Micro Political Risk

Fitzpatrick (1983, p. 250) distinguishes macro risk as 'unanticipated and politically motivated environmental changes [that] are broadly directed at all foreign enterprise' and micro risk as 'the environmental changes [that] are intended to affect only selected fields of business activity or foreign enterprises with specific characteristics.' Alon and Martin (1988, p. 12) argue that 'Micro political risks influence a select group of firms, while the macro dimension consists of more pervasive factors, such as a civil war, affecting most or all of firms in the host country.' Macro factors in political risk can originate from the governmental, social, and economic environments,

[37] According to recent reports, production has fallen from 2.5 million bbl/d in 2005 to 1.72 million bbl/d as of June 2009 (Lhuillery, 2009).

[38] According to the Economist (2003, p. 7) 'It still costs under $5 a barrel to pump Nigeria crude, so the oil firms will stay.'

and can be both internal and external. These 'Internal causes are domestically generated, while external causes are induced by the home country, a third country, or the global environment' (Alon & Martin, 1988, p. 12). Brink (2004, p. 38) refers to macro political risk as events which have an effect on all businesses in a country, while micro political risk only affect specific industries or sectors and not others. While Robock (1971, p. 9) agrees with Fitzpatrick's (1983) definition of micro risks, he differs though in his definition of macro risks in that he argues that all enterprises are affected, not only foreign enterprises.

When all businesses in a country have been affected by an event, such as political instability caused by a shift in government, this can be considered as a macro risk. An example of an external macro risk would be the sanctions imposed on South Africa in the 1980s, which had an effect on the entire country regardless of industry. This could also be the case with the 2007-2009 economic crisis which has had an effect on a number of states as a whole, notably Iceland which was forced to default on its loans, and in essence declare a form of state bankruptcy. Internally, as Robock (1971) argues, harassment or physical damage to the assets of foreign companies can take place by the local population in order to embarrass the political regime in power at that time, thus when a country faces political turmoil, foreign companies face a number of threats from all sides of the conflict. Macro risks can be indirect and spasmodic, but they can also be direct and relatively permanent, and the occurrence of a macro risk will affect all industries in a specific country, for example a change in regime leadership. An example of this permanence is the expropriation of all foreign and domestic businesses when a country experiences a Communist revolution (Robock, 1971, p. 9). Micro political risks occur when a risk has the potential to impact only on specific operations, for example in a particular industry, such as the extraction industry, or of a specific nationality (Frynas, 1998, p. 459).

As mentioned above, micro risks can be said to have arisen when political instability and uncertainty affects only specific businesses/industries/regions/ethnic nationalities. Robock (1971) argues that although macro risks are often more dramatic and visible, micro risks are more prevalent, and thus foreign investors are subject to these micro risks with greater regularity than macro risks. However, the types of investments that are affected by these micro risks differ considerably from industry to industry, region to region, state to state, or nation to nation. For example, the oil and gas industry in Africa is often subject to micro risks due to the tendency of nationalist feelings that resources and the profits derived there from belong to the people of a country not to the foreign investor. Such has been the case in Nigeria with its oil resources in the Niger Delta, and could potentially be the case with the Ogaden in Ethiopia.

Robock (1971) expands on micro risk further by arguing that some industries may face different issues of political risk at different times. At times, an industry could be less prone to political risk, while at other times it could be more exposed to such risk. He argues that political treatment of an industry might change when domestically owned industries become a reality (Robock, 1971, p. 10). In a specific industry, two factors can change the potential for micro risk over time; firstly, the higher the share of foreign owned companies in a specific industry, the higher the micro risk the industry faces. Secondly, the higher the capacity of nationals to operate the business successfully, the higher the micro risk to the industry. Those industries that require an increased number of highly skilled employees for their operations, and those that depend on a continuing import of new technology in a technologically dynamic industry face a generally low risk of for instance expropriation (Robock, 1971, p. 10).

Both macro and micro risk are factors of political risk pertaining to the broader environment and the physical foreign ownership of invested assets respectively. If a country is affected by a macro risk, this may or may not have a knock on effect that will affect that country in a micro risk capacity, and vice versa. Macro risk would be non-project specific and would affect all stakeholders in a given country, while micro risk is concentrated on a specific segment and/or region of a given country. Although the oil and gas industry in the Ogaden will undoubtedly be affected by macro risk, the focus of this research study will be micro in its analysis, having a specific industry and a specific region under investigation.

2.3.6 Forecasting and Predicting Political Risk

With regard to forecasting and predicting, Brink (2004) argues that some authors make the distinction between the two, and those who do advocate forecasting rather than predicting. Brink (2004, p. 27) contends that a 'political risk analyst cannot (and should not) predict that risk will occur, or when it will happen, but can attempt to anticipate a probability upon observing certain trends or current events, and the way in which they come together.' Logical thought dictates that it is impossible to predict certain events, if one considers the example of the 2004 Indian Ocean tsunami that hit Indonesia and surrounding countries; this was an event that was impossible to predict. Since that event, Indonesia has installed an early warning system, however it is still impossible to predict a future similar event, nor do anything to stop such an event from occurring, one can only forecast that there is a probability of the region being hit by another tsunami. This is a clear example of 'elements [of] the analytical process that prevent the prediction of specific events' (Brink, 2004, p. 27).

By the very design of a political risk model, it cannot predict when an event will occur, only forecast the probability that it may occur. This is due to the nature of the analytical method that is model dependant, and political risk models are constituted of different factors that vary from model to model, depending on investor needs. The world around us is incredibly complex, too complex to be covered systematically, thus models are used in political risk analysis to simplify this complex world, reducing it to salient features. By necessity a model leaves out certain aspects of reality, it stylises other aspects, and further it gives certain aspects more attention than others. This in effect may lead to a situation that differs from reality. Therefore, there is an abbreviation of reality, and statements about the occurrences of political risk can only be in the nature of a forecast. This is because of the simplification required when creating the model, coupled with the complexity of the system being analysed and the unpredictability of human action and interaction, which prevents the analyst from making any definite claims, or predictions, about the future. Thus the 'projection of outcomes from a given situation can only be probable, because the model necessarily simulates and abbreviates a complex set of circumstances (...) [and] the selection of representative variables and their relationships may not always result in the best possible projection' (Brink, 2004, p. 27).

Brink (2004, p. 27) warns against interchanging the terms *forecast* and *predict* in a political risk analysis, clearly defining a forecast as 'an estimate of something in the future, a probability that a certain country might pose a certain degree of political risk to a foreign investor.' Predictions are reminiscent of some kind of prophetic ability to see the future, which is impossible, it is not possible to say with certainty that an event will occur in the future, and this is the problem with using the term prediction. Forecasting is a more suitable term as it contains elements of 'a probability factor and is based on sound rational foundations, empirical evidence, scientific theory and formal procedures that include the process of systematic information gathering' (Brink, 2004, p. 28). Clearly, the tool needed for the political risk analyst is that of forecasting, not prediction, and a political risk analyst should always do the former. Robock (1971) states that forecasting political risk assumes four steps; firstly, analysts should become familiar with the political system of the country being analysed. Secondly, the analyst should identify the types of political risk to which business operations can be vulnerable (thus focusing on the specific business of the client for which the analyst forecasts the level of political risk). Thirdly, the analyst should identify the political forces or groups that are the source of political risk to the investor, and finally (based on the data gathered in the preceding three steps), the analyst should project into the future the possibility of political risk occurring in terms of its probability and its time horizons (Robock, 1971, p. 16).

Freeman and Job (1979) provide a conceptual distinction between these two concepts through their study into the nature of predicting and forecasting in international relations. They argue that predicting and forecasting share the common goal of attempting to link the *known* to the *unknown*, and the two concepts consist of three features. Firstly, they both state accepted generalisations about the relationship between certain phenomena under specific conditions. Secondly, they both contain assertions to the actual existence of such conditions at a given point in time, and thirdly, both predictions and forecasts make statements about the likelihood of an event or condition occurring at a given point in time, based upon the first assumption and given the second condition. Where these two concepts differ in logic revolves around the nature of the assertions to the actual existence of the conditions at a given point in time in establishing the likelihood of an event or condition occurring. Freeman and Job (1979, pp. 117-8) conclude that 'a forecast is a statement about unknown phenomena based upon known or accepted generalizations and uncertain conditions ("partial unknowns"), whereas a prediction involves the linkage of known or accepted generalizations with certain conditions ("knowns")'.

Forecasting includes an essential probability factor that predicting lacks and this probability factor should be derived from thorough empirical research, and well founded estimations of the likelihood of certain circumstances occurring. As a result, a political risk forecast is based on a systematic and ongoing process of data gathering, which is used to substantiate statements made regarding the political risk of the analysed area of concern to investors. The language of a forecast should always include phrases like *if... then* and words like *might*, *may* and *possible*, this clearly distinguishes them from predictions which are typically framed in a *yes* or *no* manner (Brink, 2004, pp. 27-8). There are further distinctions between forecasts and predictions, such as the fatalistic nature inherent in a prediction that focuses on a single event, while a forecast has the scope to allow for the chance of changing circumstances across a broader range of events.

Even with this clear differentiation between forecasts and predictions, and the predilection towards the former being favourable, this does not make the task or the accuracy of forecasting any easier. The data at the disposal of the analyst is often not a true reflection of the complex events and interactions taking place *on the ground*, and these events and interactions can change at anytime, as is the course of human nature. As Brink (2004, p. 28) argues, to assume rationality for all actors involved in all circumstances would be merely wishful thinking. As can be seen from the above information, this research study will build on political risk analysis as a forecasting method, with the aim of providing an accurate forecast of the political risk for investors in the oil and gas industry in the Ogaden. It should be noted that although investment

decisions are based on these forecasts, or *ex ante*, forecasting remains a continuous process for the investor, especially given the difficulties associated with the extraction of resources. Forecasts must also be done *ex post* in order to adapt to the changing environment, in order to manage possible future risk.

2.3.7 Quantitative and Qualitative Political Risk Analysis

The aim of political risk analysis is to 'identify potential actions and to select the best course of action for a specific foreign investment' (Brink, 2004, p. 31). In order to do so the political risk analyst needs to 'gain [an] in-depth understanding of the host country's investment climate as well the needs of the investor; the elements present in the host country and reciprocal impacts; and the effect they might have on the foreign investment' (Brink, 2004, p. 32). This is achieved by collecting data and information that can then be analysed to provide value in the political risk model that will be used to assess the host country. Qualitative models of political risk analysis can be seen as using *soft factors* while quantitative models can be seen as using *hard factors.*[39] In order to provide the most effective model, both the *hard* and *soft factors* should be incorporated to achieve a comprehensive political risk analysis using political, societal, and economic factors of political risk. Brink (2004, p. 12) argues that qualitative variables can be measured and quantified, by attributing weights to risk factor indicators, and these 'weights are then calculated to present a measured, probable chance that political risk might occur.'

A further problem pertaining to the methods of research and the levels of analysis, are the ecological and individualist fallacies. As Brink (2004, p. 40) describes, the 'ecological fallacy is committed when an observation that is made at the general level (over a large population) is taken and applied to every individual within that population.' The individualist fallacy is the reverse of the ecological fallacy, 'occurring when an individual level observation is made, and incorrectly generalised to the aggregate level' (Brink, 2004, p. 40). There can also be problems relating to ethnocentrisms, where western bias creeps in (as seen with the Jacob Zuma example mentioned earlier)[40] even if on an unconscious level, and comparisons are made between other political systems and western-style polyarchies, which are seen as superior to others (Brink, 2004, p. 39).

The current 'risk rating methodologies are limited and include mostly macroeconomic risk factors, measures of social structure and development, and political events that are primarily indicators of instability and/or regime change' (Brink, 2004, p. 42). Additionally the 'unit of

[39] See sub-section 2.3.3 Political Risk

[40] See sub-section 2.3.4 Political Instability / Uncertainty

analysis is almost always the nation-state, and there are related problems of reliability, accuracy, validity and comparability' (Brink, 2004, p. 42). Brink (2004, p. 42) argues that in order for there to be improvement in the field, 'What is needed is a way of conducting industry specific (type, size, structure, experience with foreign expansion), time specific (short, medium or longer term ventures), and also investment climate specific political risk analyses.' It is of the utmost importance to the validity and respectability of the analysis that the data is generated from country specific experts with full knowledge of the political processes within a host country. Coupled with this should be a thorough understanding of the prospective business itself, the more information the analyst has regarding the business, 'its structure dynamics, technological position, strategic management policies, marketing policies, as well as financial assets and liabilities' (Brink, 2004, p. 42), the more equipped the analyst is to provide a sound political risk analysis.

The central problem inherent with quantitative analysis in social science is that social interaction is difficult to represent mathematically, this is the major contributing factor to why the majority of the social sciences involve qualitative research. Subsequent problems include those associated with statistical probability, as Brink (2004) argues, political risk is not an actuality that can be analysed and calculated, it is rather a metaphor for a wide array of other phenomena. Although political risk analysts use mathematically similar words such as *chance*, *probability,* and *likelihood,* political risk analysis is not mathematical in the pure sense of the term, and should rather be considered as a judgement (Brink, 2004, p. 117). The mathematical component of political risk analysis is as part of the toolkit that aids in the weighting process of factors in models used for political risk analysis. Thus, the intention of using a quantitative approach is to come to achieve a thorough and balanced *forecast* and not a means to *predict* the statistical probability of events. However, due to the mathematical nature of the quantitative analysis, quantitative models tend to be more static than models using qualitative analysis, requiring adjustments to the weight of factor indicators for every individual situation analysed. Therefore, the process is more time consuming and more technical than qualitative models.

Qualitative analysis in political risk does not suffer from the time consuming, technical, and static issues associated with quantitative analysis, but instead relies heavily on the qualitative assessment of the analyst. The analysts use their subjective judgement to weight factors as per the situation as they see it, allowing for anomalies that would otherwise be absent from the quantitative models. Although advantageous in some areas over that of quantitative models, qualitative analysis does incur some pitfalls, notably in its subjectivity, and thus preferences of the analyst undertaking the analysis. This subjectivity removes any chance of a *scientific* analysis in

the sense that there is difficulty in repeating an analysis without achieving different results. Individuality and subjectivity result in differing preferences, and thus differing conclusions.

For the purposes of this research study, a qualitative model is preferred and will be developed for the oil and gas industry. Although some political risk models may appear to be quantitative in design, and may even be labelled as quantitative model, there is still a level of subjectivity which inherently forces models to be qualitative. This subjectivity may come in the form of assigning different weights to indicators, something the analyst must decide upon based on their own perceptions of the situation. It is for this reason that the model developed in this research study will ultimately be labelled as a qualitative model, regardless of the quantitative data or method that will be used; it is still qualitative by the very nature of the interaction with the analyst.

2.3.8 Section Conclusion

In section 2.3 Conceptualising Key Political Risk Terms Central to the Research Study, the underlying theory of political risk has been expanded upon, with all key political risk concepts relevant to this research study being examined. These concepts will be used to develop a political risk model specific to the oil and gas industry in chapter three, which will be used to examine the (potential) political risk associated with oil and gas investments made in the Ogaden. It is now clear that the political risk analysis that will be undertaken in chapter four, is a micro analysis, looking specifically at a region (the Ogaden) and an industry (the oil and gas industry). This section has provided an insight into how a political risk analysis is undertaken, showing the route that this research study will take in its application of the case study in chapter four.

2.4 Contextualisation: Background to the Conflict in the Ogaden

The conflict in the Ogaden is rooted within the history of Ethiopia itself,[41] a history that is one of the oldest in sub-Saharan Africa, and indeed one of the oldest in the world. At its base, it is grounded in a religious conflict between Christians and Muslims over resources and living space. This history has dominated the Horn of Africa with holy wars and crusade like battles so frequent they can be described with almost systematic regularity. Both sides have drawn support from whomever and wherever possible in order to achieve victory, but one thing is certain, that the area that encompasses what is the modern Ethiopian state has existed for almost two millennia (Encyclopedia Britannica, 2009).

[41] See Table 6: Ogaden Timeline 1850-2005, Appendix A, for a brief overview of events in the Ogaden

The following section will contextualise the research study by looking at the history of the conflict in the region, first by looking at the conflict between Ethiopia and Somali, followed by the conflict within the Somali Regional State that includes the Ogaden region, between the ONLF and the Ethiopian government. The final area of examination in this section will be to look at the relationship between the ONLF, the Ethiopian government, and the oil and gas companies operating in or intending to operate in the Ogaden. By briefly examining the history of the conflict in these areas, a foundation can be established to which the case study can be applied in chapter four. Figure 4 shows the spheres of influence in operation in the Somali Regional State, with the Ethiopian government affecting the most control, down to the oil and gas industry, which is seen to be the current core around which the conflict is centred in the Ogaden.

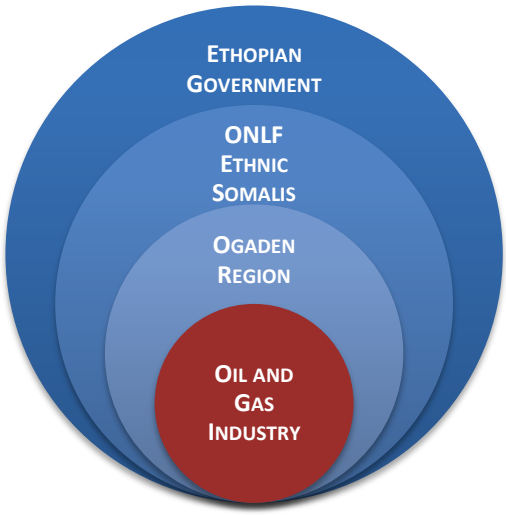
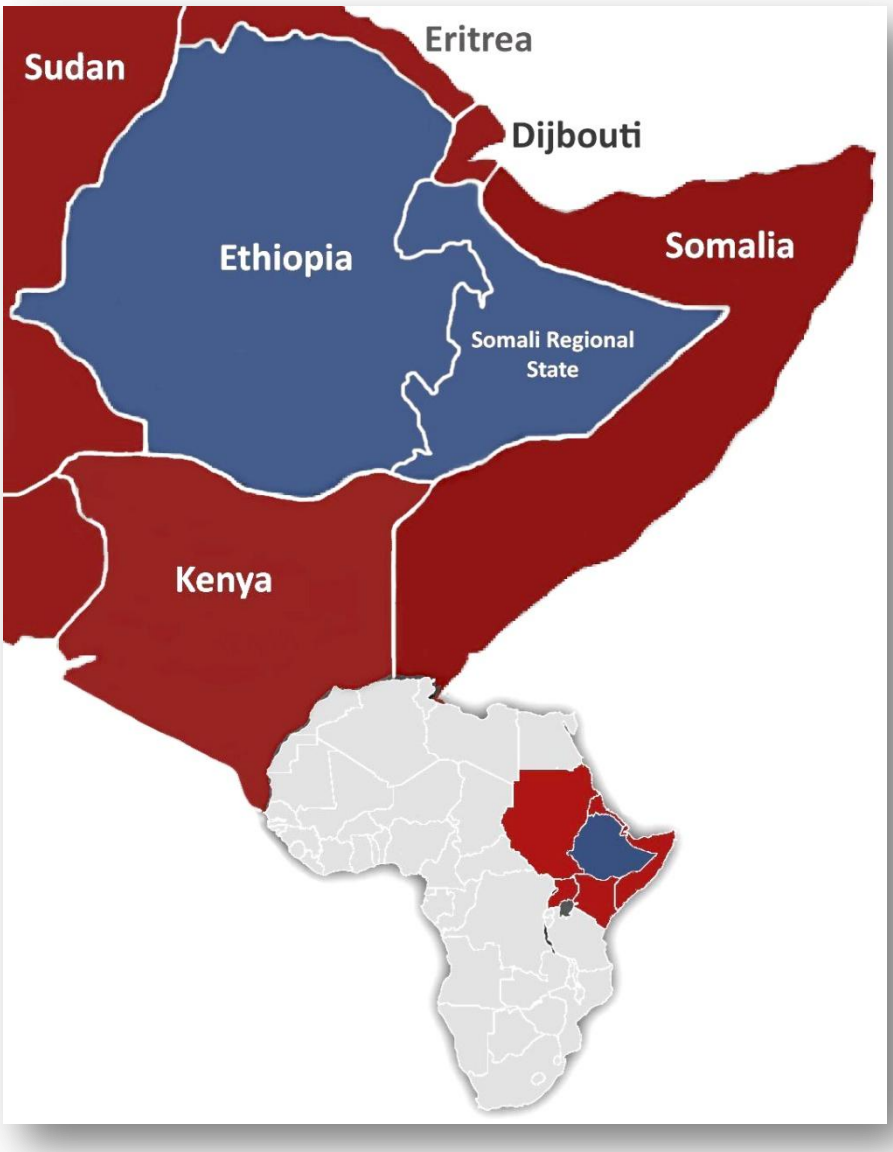


Figure 4: Contextualisation - Background to the Conflict in the Ogaden

Ethiopia is the oldest independent country in Africa and one of the oldest, enduring empires in the world (Fund for Peace, 2009b). Apart from four years[42] prior and during the Second World War (WWII), the country has been independent, and it is one of the select few countries in Africa never to be colonised. During WWII, the Ogaden fell under British rule as established in the 1942 and 1944 Anglo-Ethiopian treaties, however Addis Ababa's sovereignty over the region was never in doubt. In 1948, with support from the US, Ethiopia was able to sideline Britain who had hoped to unify the region with Somaliland, and regained full control over the Ogaden. This vision of a Greater Somaliland, which never transpired, would go on to dominate the politics of Ethiopia and Somali in subsequent years and in part still does today (Encyclopedia Britannica, 2009). This section expands on three aspects of the conflict in the Ogaden, firstly the initial struggle between

[42] From May 1936 until early 1941, Italy occupied Ethiopia, at which time they were defeated and driven out by an Anglo-Ethiopian alliance (Encyclopedia Britannica, 2009).

Ethiopia and Somalia for control of the region, secondly, the current struggle between the Ethiopian government and the ONLF (who are seeking independence in the region), and finally the relevance to the conflict of oil and gas discoveries in the region. Map 1[43] shows the location of Ethiopia (including the location of the Somali Regional State), and its geographic position relative to the region and the continent.



Map 1: Ethiopia (including the Somali Regional State and Surrounding Countries)

2.4.1 Ethiopia and Somalia: The Conflict over Control of the Ogaden

The Somalia state flag at the time of independence[44] was dominated by a star, of which three points represented what was known as the Somalia *irredenta*,[45] one of these stars represented

[43] Adapted from Map, Africa Oil Corp., 2009, p. 10

[44] 'The Mogadishu government became independent on July 1, 1960' (Encyclopedia Britannica, 2009).

the Ogaden. From the time of independence, Mogadishu made an effort to organise the young men of the Ogaden in preparation for a war of liberation from Ethiopia, and unification with Somalia. This conflict was exacerbated In February 1963, when taxes were introduced in the Ogaden by the Ethiopian government in Addis Ababa, in order to sustain development efforts in the region. These taxes incited and angered the ethnic Somalis in the region and sparked a border war in 1964 between Ethiopia (supported by the US) and Somalia (backed by the former USSR) (Encyclopedia Britannica, 2009). This boarder war continued the long conflict in the region but also introduced other factors that were systemic of the world order at the time. The Cold War, and its socialist versus capitalist aspects, backed by the USSR and the US respectively, were now also apart of the struggle in Ethiopia.

Over the next decade, the Ethiopian government in Addis Ababa dealt with conflicts in two regions of its state, in Eritrea and in the Ogaden. During this time, the US only equipped Addis Ababa with the ability to deal with interior security and frontier defence, limiting their ability to mount a major offensive beyond their own borders. The 1973-1974 oil crisis resulted in the Ethiopian government's resignation, and in its place a military central committee, called the Dergue,[46] assumed control of the country (Encyclopedia Britannica, 2009). At this time Emperor Haile Selassie, who had ruled for 57 years, was executed along with 59 members of his family (Fund for Peace, 2009b). It had been clear for some time up to this point that the military, whose leaders were increasingly becoming Marxist-Leninist in their outlook, were in fact the real power behind the weak throne in Ethiopia. In 1977, Mengistu Haile Mariam[47] was named head of state and chairman of the Dergue, and as a result of this an urban civil war ensued. It was during this time that Mogadishu chose to attack Ethiopia in the hope of gaining control of the Ogaden (Human Rights Watch, 2008, pp. 16-7).

Infiltration into the Ogaden began in May 1977 and by June of that year there were 50,000 fighters in the region prepared for the coming war, which began in earnest in July 1977. By September 1977, the Somali forces controlled 90% of the Ogaden. However, a significant role reversal was in the making as the USSR, approving of the Marxist-Leninist ethos of the revolution as well as the geopolitical position of the state, made an alliance with the Dergue that saw Ethiopia cut ties with the US and side with the Soviets. In September 1977, at the height of Mogadishu's successful campaign in the Ogaden, the USSR formally began to support Addis

[45] The three points represented were 'Djibouti, the Somali-inhabited northern region of Kenya, and the Ethiopian Ogaden' region (Encyclopedia Britannica, 2009).

[46] Sometimes the spelling *Derg* is used.

[47] Mengistu Haile Mariam was president of Ethiopia from 1977 - 1991 (Encyclopedia Britannica, 2009).

Ababa, moving its military advisors from Somalia to Ethiopia. Due to this reversal, by March 1978, Ethiopia had regained control of the Ogaden (Encyclopedia Britannica, 2009).

In 1988, after a decade of near conflict in the Ogaden, both Siyaad Barre[48] and Mengistu agreed to withdraw their forces from the region, thus circumventing further possible confrontation in the Ogaden. This was partly due to the economic decline of both countries, which had followed ruinous socialist policies in the preceding decade that had left both states ill equipped to deal with famine and drought, let alone war. Ultimately, the inability to gain control of the Ogaden lead to the downfall of the Barre regime in Somalia, and it contributed to the demise of the Mengistu regime in Ethiopia,[49] both of whom fled their respective countries in 1991. Meles Zenawi's[50] Tigray Popular Liberation Front (TPLF) headed a coalition called the Ethiopian People's Revolutionary Democratic Front[51] (EPRDF), who assumed control in Ethiopia, while Somalia disintegrated into clan units (Human Rights Watch, 2008, pp. 19-20).

2.4.2 The ONLF: The Conflict over the Independence for the Ogaden

What was initially a conflict between Somalia and Ethiopia over control of the Ogaden has (since 1991 when Somalia abandoned its attempt to assume control over that region) evolved into a conflict between the Ethiopian government and the ONLF.[52] The ONLF, founded during the Mengistu regime in 1984, is a multi-clan[53] based organisation consisting mainly of the indigenous tribe of the Ogaden, the Ogaadeeni.[54] They are a breakaway faction of the Western Somali Liberation Front (WSLF) that split in the same year. In 1992, led by the EPRDF, Ethiopia was spilt into nine regions,[55] based on ethnic and linguistic differences, each with regional autonomy, and its own president and parliament. Originally, the ONLF operated within this ethnic federalist

[48] Siyaad Barre was president of Somalia from 1969 -1991 (Encyclopedia Britannica, 2009).

[49] In May 1991 the Tigray Popular Liberation Front (TPLF) took control of Addis Ababa ousting the Dergue and Mengistu (Human Rights Watch, 2008, p. 20).

[50] Meles Zenawi is the current Prime Minster of Ethiopia, holding the position since 1991 (Human Rights Watch, 2008, p. 20).

[51] The Ethiopian People's Revolutionary Democratic Front (EPRDF), established in 1989, consists of founding members the Tigray People's Liberation Front (TPLF) established in 1975, and the Ethiopian Peoples Democratic Movement (EPDM) established in 1982 and currently known as the Amhara National Democratic Movement (ANDM). Further members include the Oromo People's Democratic Organization (OPDO) established in 1990 and the Southern Ethiopia Peoples Democratic Movement (SEPDM), previously known as Southern Ethiopia Peoples Democratic Front (SEPDF) established in 1992 (EPRDF, 2009).

[52] For background on the ONLF see footnote 22

[53] Besides the Ogaadeeni, other tribes in the region include the Mohammed Zuber, Bah Gerri, Makahil and Otology clans excluding Awlihan (Gebre-Mariam, 2005, p. 50).

[54] The Ogaadeeni are 'a member of the Darood clan family, which contain numerous sub-clans represented across the Horn of Africa' (Human Rights Watch, 2008, p. 11).

[55] A region is the highest administrative unit in Ethiopia, there are nine regions (or states) in Ethiopia.

model put forward by the EPRDF, winning over 60% of the seats in the local parliament of the newly defined Somali Regional State, comparatively the WSLF won just under 10%. The ONLF operate in five of the nine Zones[56] in the Somali Regional State, which roughly corresponds to the area known as the Ogaden, that is largely (although not exclusively) inhabited by ethnic Somali members of the Ogaadeeni clan. Map 2[57] shows the Somali Regional State divided into its nine Zones, represented here in both light grey (Fiiq, Dhagahbur, Wardheer, Gode, and Korahe Zones) and dark grey (Shinile, Jijiga,[58] Afder, and Liben Zones). The Ogaden region of the Somali Regional State is comprised of the light grey Zones (Human Rights Watch, 2008, pp. 11, 21).

Map 2: Somali Regional State

Despite the victory in the regional parliament at that time, the members of the ONLF could not come to terms with rule by Zenawi's EPRDF. They argued then and continue to argue that the

[56] Zones in Ethiopia are mid-level administrative units within a region (state), these zones are comprised of a number of Weredas, which are lower mid-level administrative units within a zone, there are 54 Weredas in the Somali Regional State.

[57] Adapted from Map 1, Human Rights Watch, 2008, p. 1

[58] The capital of the Somali Regional State, Jijiga, is in the Jijiga Zone, a non-Ogaden Zone.

EPRDF has committed atrocities against the Somali people in the Ogaden and they regard themselves 'as both an advocate for and defender of the people (...) dedicated to restoring the rights of Somalis in [the] Ogaden to self-determination, peace, development and democracy' (OgadenNet, 2009). In a statement released by the Ogaden Human Rights Committee[59] (OHRC) on 29 April 2007, they argue that 'Successive Ethiopian governments' military campaigns to quell the insurgence in the Ogaden has caused enormous human suffering in the region' (OHRC, 2007). The statement further describes the plight of the ONLF as one that has since early 1992 called 'for a referendum on self-determination and independence for the Ogaden' (OHRC, 2007).

The relationship between the ONLF and the EPRDF began to deteriorate as the ONLF continued to press for increased self-determination for the Ogaden region. This ultimately led to the EPRDF supporting the newly formed Ethiopian Somali Democratic League[60] (ESDL) that consisted of 10 non-Ogaadeeni clans. In 1995, the ESDL won 55% of the seats in the regional parliament, as well as winning 15 of the 23 seats allotted to the Somali Regional State in the Ethiopian Federal Assembly. After four years in power, the ESDL merged with a faction of the ONLF to form the Somali People's Democratic Party[61] (SPDP). However, the SPDP, like its predecessor, suffered from allegations of corruption, incompetence, and criticism over its links to the EPRDF (Human Rights Watch, 2008, pp. 21-23).

The conflict in the region has been heightened further by the instability in neighbouring Somalia, which has been without a central government since 1991. Because of this there has been an 'arms proliferation and a flourishing contraband trade' (Gebre-Mariam, 2005, p. 50) in the Ogaden which has exacerbated the conflict there. Members of the ONLF receive combat training in Somalia and upon completion, they infiltrated back into Ethiopia and to the Ogaden to continue the conflict with Addis Ababa over independence for the region. Garad (2009) argues that the ONLF are seen by the majority of Somalis and Ethiopians in the Ogaden as a 'terrorist organization because of the illegal activities (...) ethnic cleansing and child soldering, (...) illegal and clan-based killing and displacement.' When viewed from afar, the ONLF appear to represent the region, but when examined up-close, they simply represent the majority interests of a single clan in that

[59] The Ogaden Human Rights Committee (OHRC) 'is an independent, voluntary, non-political non-profit making organisation, founded on 13 June 1995, in Godey, Ogadenia, to monitor and promote the observance of internationally accepted human rights standards in the Ogaden' (OHCR, 2009).

[60] The Ethiopian Somali Democratic League (ESDL) 'was set up in February 1994 by merging some dozen Somali political and clan groups. (...) Though it has little support among the Ogaden, the ESDL is backed by the northern clans, the Issaq, Dir (Issa, Gadabursi, Gurgure) and the non-Ogaden Darod (Bartire, Yabare, Mejertein, Dhulbahante). Some southern Hawiye clans (Garre, Digoodiya) also support the ESDL' (Sellassie Family Web, 2009).

[61] The Somali People's Democratic Party (SPDP) was created from the merger of the ESDL and a splinter group of the ONLF in 1998 (Human Rights Watch, 2008).

region, the Ogaadeeni. According to Garad (2009), even the ONLF now realise that they cannot achieve independence 'without having the majority of non-[Ogaadeeni] Somali clans on board.'

This view is supported by Pham (2007), who argues that the 'conflict in Ethiopia's Somali Regional State does not occur in a vacuum, but rather takes place within a dynamic regional context' which includes Eritrea and Somalia. Pham (2007) argues that the ONLF does not necessarily represent all the ethnic Somalis in the Somali Regional State, which he argues is often incorrectly termed the Ogaden. Further, he states that the 'nature and extent of the group's base is difficult to determine' and that 'What is certain is that there are ethnic Somali sub-clans in the region whose members the ONLF clearly does not represent as well as sub-clans, particularly among [Ogaadeeni] lineages, which have considerably closer ties with the eponymous group' (Pham, 2007).

2.4.3 The ONLF, the Ethiopian Government and Oil and Gas Investments

In terms of the relationship between the ONLF, the Ethiopian government, and the oil and gas companies, the discovery of natural gas, and the exploration into crude oil deposits in the Ogaden, has only added to the tension already present in the region. On 8 June 2009, the ONLF released a statement via the Ogaden News Agency (OgadenNet.Com) regarding oil exploration in the Ogaden. Below are the salient points from that statement that highlight the position of the ONLF with regard to the Ethiopian government and the oil companies:

> *'[The ONLF] has ascertained that certain multinational Oil corporations are intent on exploiting Ogaden fossil fuel resources in alliance with the current Ethiopian regime that is committing genocide and War Crimes in Ogaden.* (...) *Besides destroying the livelihood of the rural population in the affected areas, these companies are filling the coffers of this regime and financing its criminal activities in occupied Ogaden.* (...) *Thus, these companies are accomplices to the Ethiopian regimes crimes and are directly involved in the on-going genocide in the Ogaden.* (...) *Furthermore, the current regime in Ethiopia is bent on further usurping their natural resources, and these multi-national companies are party to this heinous crime perpetrated against a colonised stateless people. Since ONLF has persistently warned these unscrupulous multinational companies and their governments, it is very clear that they are not only manifestly disregarding the plight of the Ogaden people but are actively participating in the violation of the Human and Political rights of the Ogaden people, the Ogaden National Liberation Front has been left no alternative but to take all measures necessary to protect the inalienable rights of the Ogaden people' (OgadenNet, 2009).*

This statement clearly outlines a number of views held by the ONLF regarding the region and its resources, of which the key points are listed below. Firstly, they view the actions of the oil and gas companies in conjunction with the Ethiopian state as exploitative, and both are responsible for committing genocide and war crimes. Secondly, they blame the oil and gas companies for the destruction of their natural habitat and the displacement of their people and thus their livelihood.

Thirdly, they see the exploitation of the region as financing the central Ethiopian government. Fourthly, they see Ethiopia as an occupying force who inflict harm on the colonised local population, which is stateless, in order to benefit the oil and gas companies, who are thus complicit in that harm. Finally, they argue that for the above reasons, the ONLF has been left with no alternative but to ensure the protection of its land, resources, and people, by whatever means necessary.

Pham (2007) argues that the ONLF has had a long-term opposition to the oil and gas concessions in the Ogaden being award by the Ethiopian government to foreign companies, and that they have been on record to this effect. This opposition also includes other development projects in the region, and at the heart of this opposition is the connection with the Ethiopian government, which sanctions and co-ordinates these concessions and developments (Pham, 2007). It is clear that the resources of the Ogaden, particular the petroleum reserves, have become a central feature in the conflict in the region, and have compounded the call for independence. The members of the ONLF see these resources as theirs, and not belonging to Ethiopia and its government in Addis Ababa, and the oil and gas companies in the region are complicit with the government and therefore action can be taken against them. This statement, although released in 2009, has been part of the ONLF thinking for some time, as evidenced by the 2007 attacks on the Petronas funded Chinese oil exploration venture, which will be examined in chapter four.

2.4.4 Section Conclusion

In section 2.4 Contextualisation: Background to the Conflict in the Ogaden, the purpose has been to contextualise the research study by looking at the history of the conflict between Ethiopia and Somalia, followed by the conflict within the Somali Regional State that includes the Ogaden region, between the ONLF and the Ethiopian government. Further, this section looked at the relationship between the ONLF, the Ethiopian government, and the oil and gas companies operating in the region. The conflict that has existed in the Ogaden this century (and for much of the previous one) is rooted in the reality that culturally and economically the ethnic Somali population of the region remains intertwined with bordering Somalia. According to Human Rights Watch 'Conflicts within and over the region have evolved in tandem with many of the 20th century's most significant national and regional developments in the Horn of Africa' (Human Rights Watch, 2008, p. 12). These include colonial division that separated the Somali people, the creation of Somalia in 1960, and the collapse of Barre regime in Somalia in 1991. The clan based ONLF have tried politically to push for autonomy in the region, and having failed at this level, they

have organised themselves militarily and have in the past decade sort to disrupt the Ethiopian government's position in the region, which has intern led to action against the ONLF and the region by the Ethiopian government. The discovery of oil and gas in the region has only exacerbated efforts from both sides to win control over the Ogaden, and the presence of foreign oil and gas companies has created an easy target for the ONLF in their attempts to undermine the Ethiopian government, in their continued pursuit for independence in the region.

2.5 Conclusion

The focus in this chapter has been on the conceptualisation of key political risk terms central to this research study, as well as looking at the history of the conflict in the Ogaden from the Ethiopian government, Somali, and ONLF perspectives, taking into consideration the discovery of petroleum reserves in the Ogaden. By undertaking this examination of the theoretical perspective, looking at key political risk concepts, a framework is developed on which an industry specific political risk model can be developed in chapter three. By contextualising the history of the conflict in the Ogaden, looking at key stakeholders, a foundation is established to which the case study can be applied in chapter four.

Chapter three will focus on political risk analysis specific to the oil and gas industry. Here political risk will be reviewed in terms of its relationship with the global environment and the oil and gas industry. The factors and indicators relevant to a political risk analysis for the oil and gas industry will be discussed, based on an examination of existing models, and those variables defined by industry experts and other authors. Further, chapter three will focus on the methodology of building a political risk model specific to the oil and gas industry. Together, this analysis forms the basis for the industry specific political risk model developed in this research study, which will be applied to the case study in chapter four to assess the political risk for investors operating in, or intending to operate in the oil and gas industry in the Ogaden. Chapter three will conclude by examining political risk in terms its role as a decision-making and management tool for the investor, and the investment.

CHAPTER THREE: POLITICAL RISK ANALYSIS SPECIFIC TO THE OIL AND GAS INDUSTRY

3.1 Introduction

The focus of the following chapter is to develop a framework based on the underlying theory of political risk set out in chapter two by disseminating the literature that focuses on the practical or *on the ground* application of political risk. The objective here is the development of a political risk model specific to the oil and gas industry. A brief analysis of political risk and its relationship to the global environment and the oil and gas industry in general will provide insights into the changes in typical political risk issues faced by this industry in the 20th and 21st centuries. Industry specific political risk analysis will be undertaken with an examination of the IHS model, the sources of political risk faced by the extraction industry as defined by Control Risks, and variables relevant to the oil and gas industry as suggested by Alon et al. (2006), Berlin (2003) and Lax (1983). Further, this chapter will also focus on the methodology of building a political risk model for the oil and gas industry, and analyse the simplified political risk model developed by Alon et al. (2006) for industry specific adaptation. The information attained from the analysis of IHS, Control Risks, Alon et al. (2006), Berlin (2003), and Lax (1983), will form the basis for the political risk model for the oil and gas industry developed in this research study.

By using an industry specific political risk model, the risk assessment conducted in chapter four for the oil and gas industry in the Ogaden will be more precise and relevant, and therefore the risk evaluation for investors will be more accurate. As mentioned in chapter one,[62] there are limitations regarding access to existing political risk models as they are considered an intellectual property right of those companies who have developed them. What is known of these models in general has been reconstructed through a process of reverse engineering, by authors who have examined the actions taken by the companies using them. Throughout this chapter, the factors and indicators (collectively termed variables) which are relevant to the oil and gas industry (on both a micro and macro, internal and external level) will be presented and discussed. These variables have been identified in an attempt to define political risk and its relationship to the oil and gas industry.

The conclusion to this discussion will be the presentation of the salient factors and indicators selected for the industry specific political risk model to be developed here. This will be followed by the political risk model specific to the oil and gas industry, and a simple risk grading scale for assessing the results of the model, as well as some guidelines for both analysts and

[62] See section 1.6 Limitations and Delimitations of the Research Study

investors. For a political risk analysis without knowledge of the investor the political risk model will be termed a *phase one political risk analysis*. The components of a political risk analysis that include knowledge of the investor and thus the home country and the investment itself, will be termed a *phase two political risk analysis*. Thus *w*ith complete knowledge of the investor the analyst is able to undertake a *phase one* and *phase two political risk analysis*. For the purposes of this research study and the risk report presented in chapter four on the oil and gas industry in the Ogaden, only a *phase one political risk analysis* will be undertaken, as there is no knowledge of the investor available.

Finally, the chapter will conclude with a look at political risk analysis as a decision-making tool (risk assessment), as well as a means to manage the political risk associated with an investment (risk mitigation). A comprehensive political risk assessment may include advice to the investor about the ways and means of managing potential political risk. Although not part of a political risk model, the information gathered by the analyst, would expose and create an awareness of aspects and elements of the country or region under investigation, which may assist the investor when it comes to mitigating possible these political risk. This knowledge can be presented as part of the political risk assessment as recommendations or suggestions for a successful entry into, or continued success in the country or region the investor is operating or intending to operate in. This expands on the validity of political risk and the analysis thereof, and its significant contribution to making the correct decision when investing, as well as maintaining an investment.

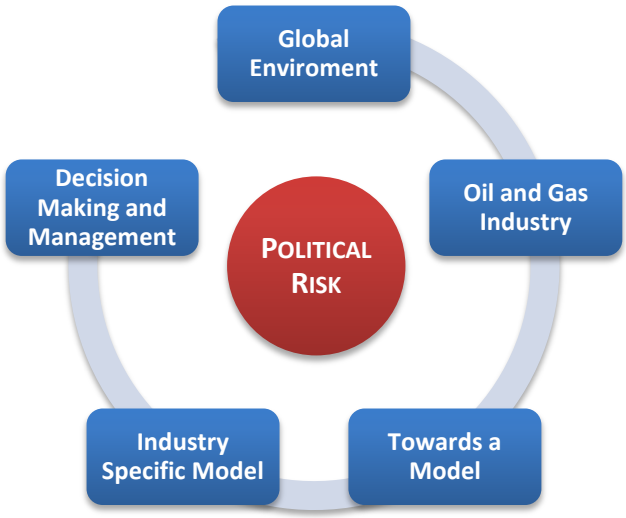


Figure 5: Political Risk Analysis Specific to the Oil and Gas Industry

Figure 5 shows the course this chapter shall follow, beginning with the relationship of political risk to the global environment and ending with the decision-making and management aspects of political risk analysis.

3.2 Political Risk and the Global Environment

Brink (2004, p. 39) describes the global component of political risk analysis as that consisting of 'all international systemic factors that may affect government and societal behaviour.' With this understanding, indicators of the global environment would 'point toward geographic position and geo-politics, systemic status-rank, and the level of systemic conflict that might influence a host country's stance toward [FDI]' (Brink, 2004, p. 39). It should be noted that the internal and external events that contribute to the occurrences of political risk 'are constantly influencing the severity and degree to which risk factors influence investments' (Brink, 2004, p. 26). The global environment is a dynamic one that involves constant change and new configurations, and thus perceptions of political risk are susceptible to change. In this sense, political risk analysis has to be based on fundamentals, which include a comprehensive look at a country's political and economic systems, thus allowing the political risk analyst the ability to forecast a country's reaction to changes in the global environment. Models tend to become static in an ever changing global environment, which is a clear 'weakness of a structural analysis of political risk, [which can be overcome] by maintaining constant awareness that social patterns are continually evolving as they interact' (Brink, 2004, p. 43).

The following statement by Control Risks (issued through the Multilateral Investment Guarantee Agency) provides some insight into the changing nature of political risk. They argue that:

> *'The events of the latter half of 2008 mean that "political risk" may be a term less frequently reserved for descriptions of emerging or semi-emerged economies. Unprecedented state interventions in those business sectors that had formed the true embodiment of apolitical free markets (banking, insurance, retail and manufacturing) may have somewhat re-defined political risk. Even if the "rising tide of Western protectionism" some have predicted does not occur, there will be, at the very least, an inevitable impact on the insurance market's pursuit of new political risk business. Developed states' responses to the financial crisis have also ended the traditional insurer's portrayal of political risk, which may no longer fit the conventional scenarios such as an autocrat in a less developed country arbitrarily decreeing state ownership over foreign-owned business assets' (Multilateral Investment Guarantee Agency, 2008).*

The top 10 risks for 2009 as identified by Eurasia Group[63] further highlights this need for adaptability and the changing nature of political risk. This list is headed not by an unstable, highly violent and insecure state, such as Iraq (which holds the number five position), but surprisingly,

[63] 'Established in 1998, Eurasia Group is the world's leading global political risk research and consulting firm, they help clients make informed business decisions in countries where understanding the political landscape is critical, their headquartered are in New York, with further offices in Washington and London, as well as a vast network of experts around the world' (Eurasia Group, 2009).

the top position is held by the US Congress. Ian Bremmer (2009), president of Eurasia Group states:

> *'... political risks have historically been most important for economic outcomes in emerging markets, but that's not so this year. The current financial crisis has created an unprecedented space for government interference in economic affairs within developed states, as well. Nowhere is that more true than in Washington.'*

This shows a reformulation of political risk, no longer simply associating the field with unpredictable, autocratic, peripheral, and semi-peripheral states, but establishing political risk's significance as a truly global phenomenon.

3.3 Political Risk and the Oil and Gas Industry

When assessing the relationship between the oil and gas industry and political risk, according to Alon et al. (2006, p. 626), 'It should be noted that defining and assessing political risk is a dynamic and evolutionary process for both academics and practitioners alike.' As stated prior, political risk analysis is not static; it is a motive undertaking which is constantly active in changing and developing in order to provide the most accurate assessment possible. A political risk analysis requires that the analyst is constantly aware of the changing nature of the environment being assessed. Thus, ongoing developments are taken onboard in the assessment, gradually increasing the complexity of the analysis and thus providing a more accurate assessment. This dynamic and evolutionary process affects the nature and scope of political risk itself, which is directly related to the country or region under investigation, the time it is being investigated, the investors, the industry, and the stakeholders involved (Alon et al., 2006, p. 626).

According to Berlin (2003) 'an oil company must be able not only to find hydrocarbons, it must be able to develop and produce those hydrocarbons at a reasonable profit over time.' In order to do this successfully, the investor must be aware of not only the geological and market risks, but also the political risk represented by the host country. This is particularly true of oil and gas investments 'which are high profile and often controversial in almost every country in which the energy industry has been privatised' (Berlin, 2003). It is important to acknowledge that signed concessions between companies and the host country usually carry a term that will extend beyond the period of the government who signed them will remain in office. Thus, it is necessary to be mindful of what future governments might do in terms of the investment, especially if a government comes to power that is less disposed to Western companies, and therefore may embark on a 'more nationalist policy for their natural resources' (Berlin, 2003).

According to Berlin (2003), the type of political system a host country has in place be it capitalist, Marxist, socialist, nationalist, monarchy, or democracy, does not affect the political risk

of the investment. Oil and gas companies have worked in and with host countries with all these political systems, sometimes with great success. Political risk should rather been seen as 'changes to the political and socio-economic conditions of the host country from those that existed at the time the agreements in question were originally entered into' (Berlin, 2003). This was the case for Belco Petroleum Corporation in Peru in the 1980s, at which time a change in the government resulted in a change in the political risk for Belco in the form of an anti-foreign investment attitude that was not present with the previous government. Likewise Enron Corporation had a similar problem in India in the 1990s, where a change in the regional government resulted in a change of policy towards foreign investors in that region, including Enron. This is not to say that these kinds of events only occur in the developing world. At times, the governments of Britain, France, and Italy for example have through changes in legislation, represented a political risk to investors through what has become known as *creeping* expropriation (Berlin, 2003). For example, the windfall-profit taxes levied by the newly elected Labour government in Britain in 1997, against privatised former state entities, such as British Airways and British Telecom, can be considered a form of *creeping* expropriation.

3.3.1 20th Century Political Risks

In the 20th century, nationalisation was amongst the highest political risk faced by investors in the oil and gas industry. This period saw a number of governments taking back national resources that were held in the hands of foreign investors. Prior WWII, the oil and gas industry was dominated by seven major oil companies, known as the *Seven Sisters,*[64] all of which had worldwide concessions. These concessions were mostly in the Middle East, but also in Asia as well as other developing countries (Boulos, 2003, p. 4). The first significant political risk faced by the oil and gas industry came in March 1938, when an order signed by then Mexican President Lázaro Cárdenas nationalised all foreign oil companies operating in Mexico. According to Bremmer and Keat (2009, p. 8) , this 'decision yielded estimated losses of $200 million for U.S. companies and similar loses for Anglo-Dutch investors.' This example of nationalisation or expropriation highlights 'several factors that have traditionally led governments to seize private property and foreign direct investment: ideology, nationalism, domestic interest groups, national economic development, and geopolitics' (Bremmer & Keat, 2009, p. 8). The losses that occurred in Mexico were significant but not the norm, and in general most independent or small companies generally steered clear of international exploration. Only the *Seven Sisters*, who controlled 90 percent of

[64] The *Seven Sisters* are BP, Shell, Exxon, Mobil, Chevron, Texaco and Gulf (Boulos, 2003, p. 4).

the world's oil production prior to WWII, were willing to assume risks internationally (Boulos, 2003, p. 4).

In the post WWII period, nationalisation of international oil company concessions occurred in Iraq, Syria, Algeria, Argentina, Venezuela, Ecuador, Libya, and Nigeria amongst others. During this period, political risk was on top of the agenda when it came to investing in the oil and gas industries of foreign countries for two main reasons. Firstly, the decline of colonisation led to states seeking control of their national natural resources, and secondly, this coincided in 1963 with a UN Resolution on Permanent Sovereignty over Natural Resources. This resolution recognised the 'right of all States freely to dispose of their natural wealth and resources in accordance with their national interest and in respect for the economic independence of states...' (Boulos, 2003, p. 5). According to Markwick (2001, p. 39) 'foreign investment in infrastructure or national resources tends to provoke nationalist sentiment,' with Morgan (1998, p. 70) adding that the extraction industry is the 'most sensitive of all international corporate activities.' As Alon et al. (2006, p. 631) summarises, this is largely due to operations in and around the extraction industry being linked to a country's 'wealth, international prestige, and power.'

3.3.2 21st Century Political Risks

With the onset of globalisation throughout the remaining two to three decades of the 20th century, nationalisation declined as a political risk, but did not disappear completely.[65] Integrated financial systems, the World Bank, the International Monetary Fund (IMF), as well as the privatisation of National Oil Companies (NOCs) all contributed to the decline of nationalisation as a political risk (Boulos, 2003, p. 6). This decline has resulted in a 'corporate shift from forecasting to managing political risk' (Alon et al., 2006, p. 626). However, even with this major threat to oil and gas companies investing in foreign countries being neutralised by market orientated economies and privatisation, according to Boulos (2003, p. 6) 'Political issues continue to play a major role in the determination of whether to invest in a petroleum venture in a foreign country.' Boulos (2003, p. 6) argues that the focus in the 21st century is on international political issues, domestic political issues, international business practices, corporate responsibility, and risk mitigation strategies. The political risks associated with these categories include; 'expropriation, revolution, civil disorder, creeping expropriation, unilateral imposition of new taxes and royalties, imposition of export controls or withdrawing licenses for export or import, exchange control

[65] Nationalisations and expropriations have occurred in varying degrees in a number of countries in the 21st century, notably Russia (post 2003), Bolivia, (2006), Ecuador (2007), and Venezuela (beginning in 2007) (Bremmer & Keat, 2009, pp. 22-45n.5).

restrictions and other factors that reduce or destroy the value of the international oil and gas venture' (Boulos, 2003, p. 15).

The companies and authors that are examined in the following section of this chapter take on board this decline in nationalisation and show the dynamic and evolutionary nature of political risk analysis. Today, investors in the oil and gas industry 'are influenced to a large extent by risk of wars and external threats, taxation systems, terrorism, civil and labour unrest, corruption, governmental regulations, repatriation restriction, political instability, energy vulnerability, and environmental activism, to name a few' (Alon et al., 2006, p. 631). However, despite these potential risks that the oil and gas industry face, 'companies are able and willing to work in almost any country in the world' (Hallmark & Whited, 2001, p. 22). This means that commissioning a political risk assessment from a firm specialising in political risk analysis, or drawing on an internally established division[66] for such an assessment is 'primarily an *ex ante* decision made to inform operating decisions going forward' (Alon et al., 2006, pp. 631-2). Globalisation and the need for increased energy recourses have motivated companies to invest in high risk areas as long as the financial returns are equally high. These investors are prepared to accept 'a high degree of risk if they foresee that they can sufficiently manage the risk to ensure profitability' (Alon et al., 2006, p. 632).

An article in the Economist published in September 2008, titled *Oil, politics and corruption* states that 'Political risk is arguably more pervasive and fundamental to who makes or loses money than at any other time since the Second World War.' Although political risk seems most prevalent within emerging markets, this is not always the case. For example, in 2005 the Chinese National Offshore Oil Company (CNOOC) attempted to purchase Unocal, an American based oil company, but was met with opposition from the US Congress, and ultimately failed in acquiring Unocal. Thus political risk has scope and relevance in not only the emerging markets of the developing world, but also in the established markets of the developed world. According to General Electric (GE) Chief Executive Officer John Rice (The Economist, 2008), 'Developed-country governments do unexpected things that are every bit as troublesome as emerging markets or governments. If you are an oil and gas company today, do you worry more about emerging markets or a windfall-profit tax in the US?' Thus, although political risk is a greater concern in emerging markets, this is not always the case and political risk analysts should be mindful not to confine their analysis to only one area.

[66] According to the Cambridge Energy Research Associates (CERA), Shell 'got the message about political risk 30 years ago' and have since the early 1970s had a political risk division within their corporate structures that advises the company on political risk related to their investments (The Economist, 2008).

In addition to the risks that investors in the oil and gas industry face as mentioned earlier, there are also 'trade regulations, embargoes, quantity restriction, and excessive bureaucracy' (Alon et al., 2006, p. 632). Together these risks make it impossible for companies not to 'adopt political risk assessment and risk management programs on a continual basis' (Alon et al., 2006, p. 632). Thus, political risk analysis has become an important and integral part of the oil and gas industry, and investments rarely occur without some form of political risk assessment taking place. This integration into the oil and gas industry has resulted in political risk increasingly being used as not only a decision-making tool, but also a management tool for the oil and gas industry. The willingness to deal with or accept political risk varies from investment to investment, as Berlin (2003) argues, 'there is usually a direct correlation between the degree of political risk that a company is prepared to accept, and the degree of geological potential of the proposed contract area.'

3.4 Towards a Political Risk Model for the Oil and Gas Industry

In order to assess political risk within a specific industry, the analyst must consider 'the possibility that political decisions, events or conditions in a state, including those that may be termed social, will affect the business environment in such a way that firms loose money or have a reduced profit' (Venter, 1997, p. 5). According to Venter (1997, p. 5) the central problem faced by companies when it comes to political risk, is the difficulty in controlling those risks, 'A war, a civil uprising, a terrorist bomb attack (...) cannot be put under management control or even industry-wide control.' However, in large industries such as the oil and gas industry, these events can and should be anticipated with careful planning and foresight. Venter (1997, p. 5) reminds us that 'Political risk events are discontinuous (...) [and that] they are not predictable on the basis of statistically based generalisation (...) [being] too few and too disparate to be the subject of such generalisations.' However, a continuous descriptive assessment of political, economic, and social trends within a country or region 'can provide decision makers with early warning signals of impending political risks' (Venter, 1997, p. 5).

As Venter (1997, p. 6) argues, 'It is fundamental at the onset of a political risk assessment to draw a basic distinction between "macro" and "micro risks."' Some of the risk factors mentioned earlier in this chapter[67] such as war, terrorism, labour unrest, political instability, corruption, amongst others are *macro risks* and to varying degrees, affect almost all industries and sectors. Other factors mentioned, such as energy vulnerability, environmental activism, and restrictions on oil and gas exports are *micro risks*, and are industry specific factors that affect only

[67] See section 3.3 Political Risk and the Oil and Gas Industry

the oil and gas industry. In conducting a political risk analysis, it is essential to take on board both macro and micro variables, with an understanding that micro variables may have a far greater effect given their industry specific nature.

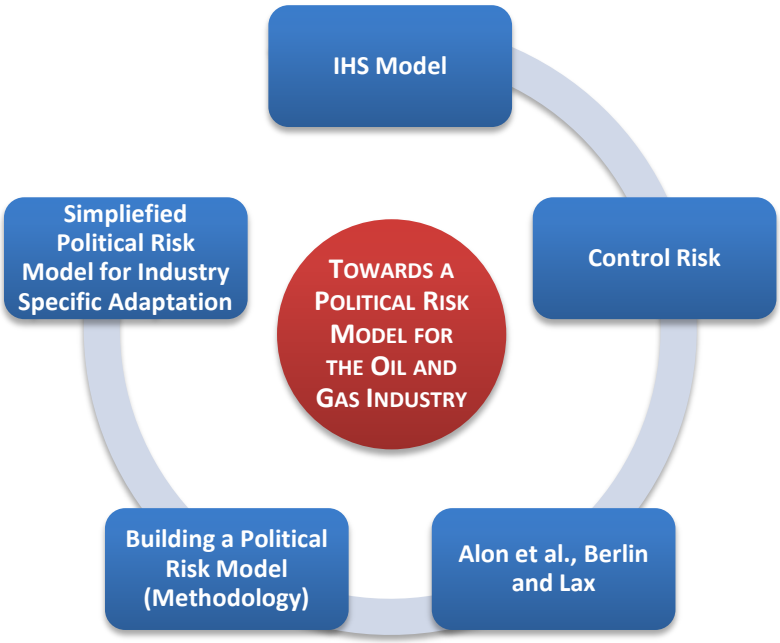


Figure 6: Towards a Political Risk Model for the Oil and Gas Industry

Figure 6 shows the course this section will follow, beginning with an examination of the IHS model. This is followed by the sources of political risk faced by the extraction industry as defined by Control Risks, and factors and indicators relevant to the oil and gas industry as suggested by Alon et al. (2006), Berlin (2003) and Lax (1983), which will be examined for their insight and specific approach or position toward political risk. These companies and authors continue the long tradition begun by Shell's Assessment of Probabilities / Subjective Probabilities Assigned to Investment Risk (ASPRO/SPAIR) model,[68] which was used before, during and after the 1973-1974 oil crisis, to manage Shell's risk in terms of political and economic events that affect the oil and gas industry (Alon et al., 2006, pp. 632-3). As Alon et al. (2006, p. 633) argue, 'Because of the competition inherent in oil exploration, companies are willing to accept a high degree of risk if they believe [that] risk can subsequently be managed to achieve profitability.' Further, as shown in Figure 6, this section will also focus on the methodology of building a political risk model for the oil and gas industry, before analysing the simplified political risk model developed by Alon et al. (2006) for industry specific adaptation. Together with the information attained from the analysis

[68] At the time of its creation ASPRO/SPAIR model was 'perhaps the most specific methodology for analysing political risk in the oil industry.' The model, created by Shell, is designed to 'address the particular political concerns of firms that are investing in petroleum products abroad' (Lax, 1983, p. 144).

of IHS, Control Risks, Alon et al. (2006), Berlin (2003), and Lax (1983), this will form the basis for the political risk model for the oil and gas industry developed in this research study.

3.4.1 IHS

As has been discussed previously,[69] there are limitations to this research study regarding political risk models, in that access to these models is problematic. However, much more is known about the actual model that IHS use for political risk analysis in the oil and gas industry, than compared to other companies. The model developed by IHS has been used by the Société Générale's[70] (SG) equity research team to identify risks faced by BP[71] and other energy companies.[72] The three major risk factors identified by the IHS model are; political, economic and commercial petroleum, with each of these factors being supported by a number of indicators, which brings the amount of variables utilised to 11. When an opportunity presents itself for an investment, IHS ranks the host country on a scale of 1 to 5 for each of these 11 variables, with 0 representing *risk free* and 5 indicating *maximum risk potential*. Weights are then assigned to these 11 variables in the form of a percentage for each variable totaling 100 percent across all 11 variables. The rating (1 to 5) is then multiplied by these percentage weights, the sum of which is then divided by 11, to produce an overall political risk rating for the country in terms of its investment potential (Alon et al., 2006, p. 634). The IHS model is qualitative given the ability of the analyst to assign different weights to different variables, as well as different scores to each variable. However, it contains quantitative elements and it uses a 'comprehensive index to measure the political risks [IHS] encounters in its foreign operations' (Alon et al., 2006, p. 634).

According to Alon et al. (2006, p. 634) 'The IHS index offers easy quantification of different variables of political risk,' and they identify the 11 variables used by IHS (with their respective percentage weights). They are as follows; war and external threats (6%), civil and labour unrest (15%), internal violence (21%), regime instability (18%), economic instability (5%), energy vulnerability (4%), environmental activism (6%), ethno-linguistic factionalism (5%), investment, constraints (7%), repatriation restriction (5%), and the threat of adverse changes in contracts/fiscal terms (8%). From this list, it is possible to determine that *civil and labour unrest*, *internal violence*, and *regime instability* are of significant importance to IHS, given that these

[69] See section 1.6 Limitations and Delimitations of the Research Study

[70] Société Générale is a leading European financial services companies and one of the oldest banks in France, with extensive financial service activities throughout Europe and the rest of the world (Société Générale, 2009).

[71] 'BP [formerly British Petroleum] is one of the world's largest energy companies, providing its customers with fuel for transportation, energy for heat and light, retail services and petrochemicals products for everyday items' (BP, 2009).

[72] Including Shell, TotalFinaElf, Eni and Repsol YPF.

three factors account for 54% of the model's weight. These variables are clearly important and relevant, and thus high on the list of those to consider selecting when developing a political risk model for the oil and gas industry.

A study conducted by SG on historic country risk profiles counters the preferred notion that political risk analysis is *ex ante*, by suggesting that there is no positive correlation between political risk and returns to shareholders. According to Alon et al. (2006, pp. 634-5), as a result 'the IHS index almost suggests that companies should be prepared to "buy or sell countries" based on risk profiles.' What can be deduced from the IHS model that is used to measure encountered political risks is that it implies that political risk analysis, for them, is a management and not a decision-making tool. However, the IHS model can and is used as a decision-making tool as well as a management tool. What this approach indicates is 'the eventual need for any energy-sector company to conduct a detailed political risk analysis of every place of its business operations' (Alon et al., 2006, p. 635). Therefore, if political risk analysis is part of a company's culture and organisation, at all levels, political risk 'can be managed successfully through the adoption of effective risk assessment and risk mitigation strategies' (Alon et al., 2006, p. 637).

3.4.2 Control Risks

According to Control Risks, the traditional political risks faced by investors have changed over the past few decades as globalisation has levelled the playing field. As mentioned earlier in this section,[73] events such as expropriation and nationalisation, although still a concern, are occurring less frequently and with less ferocity. The idea that political risk stems only from the action and inaction of national governments is not inclusive enough to cover all the political risks faced by investors. Control Risks argue that 'Political risk can stem from local governments, international and local [Non-Governmental Organisations] NGOs, community groups, local competitors or any other group advancing political objectives' (Control Risks, 2009a). The oil and gas industry faces a number of particular risks that are quite varied; these include corruption, NGO scrutiny, maintaining a social licence to operation, a lack of clarity over the implementation of mining legislation, through to poor infrastructure and HIV/AIDS. According to Control Risks (2009a), these changes in the political risks faced by investors have been brought about by factors such as: decentralisation of governance in many emerging market economies; enhanced ability of NGOs to scrutinise extraction companies in remote locations via significant advancements in information technology; and a rising level of expectations of behaviour for the extraction industry by shareholders and the general public.

[73] See section 3.3 Political Risk and the Oil and Gas Industry

Control Risks (2009a) identifies the following sources of political risk the extraction industry faces. There are four main risk factors each with a number of supporting indicators. They are *Politics and Governance* (political instability, unclear legislation/security of tenure, corruption/poor governance, and changing royalty/tax regimes), *Security* (civil unrest/ethnic conflict, kidnapping, insurgency and terrorism, labour unrest, and theft and pilferage), *Reputation and Social Issues* (community opposition/social licence to operate, artisanal miners, joint venture (JV) partner reputation, and human rights), and *Infrastructure and Health* (HIV/AIDS, disease, lack of transport, and communications infrastructure). Many of these sources of political risk are often inter-related, for example, 'a local community grievance can be seized upon by a local politician and/or an international NGO, and the grievance could become a security issue' (Control Risks, 2009a). From the factors and indicators presented by Control Risks, it can be deduced that the traditional large, catastrophic, *force majeure* type risks have given way to variety of *mid-tier* risks, which are often inter-related. Further, analysing political risk requires focusing beyond the actions of a national government, looking more to the local and regional levels (Control Risks, 2009a).

This look at Control Risks' position toward political risk reveals similar results to IHS's position. That managing political risk is the key to mitigating political risk, and that a '21st century mining company will have to become a master at managing political risk' (Control Risks, 2009a) in order to be successful. Companies wishing to enter or maintain their investments in foreign countries or regions must 'make sophisticated, informed and rational decisions about political risk and (...) manage the implementation of value creating risk management programs' (Control Risks, 2009a). In sub-section 3.6.4 Comparing Approaches: BP, IHS, and Control Risks, a tabular summary will be provided of these two companies and their approaches to political risk (also including BP's approach that will be discussed later[74] in this chapter).

3.4.3 Relevant Factors and Indicators

Alon et al. (2006), Berlin (2003) and Lax (1983) suggest certain factors and indicators relevant to the oil and gas industry, and these include a number of variables that may affect that industry on a macro level, such as general political, economic, and social risks. Indicators of these risk factors include exchange rate fluctuation, local content regulations, adverse balance of payments situations, threats of war, unstable political and economic environments, terrorism, civil and labour unrest, as well as others. It is true to say that these board macro factors and indicators not only may affect the extraction industry, but 'may affect any sector of the economy' (Alon et al., 2006, p. 639). On a micro level, the oil and gas industry is affected by a number of unique factors;

[74] See sub-section 3.6.3.2 BP

indicators and these include environmental activism, energy vulnerability, and constraints on oil investment amongst others.[75] According to Alon et al. (2006, p. 639) analysts, in undertaking a political risk analysis, should be mindful of these 'unique, industry-specific micro political risks, while at the same time taking into consideration the general macro political risks.'

Berlin (2003) makes the distinction between *firm-specific* (micro) political risks that are by nature discriminatory, and *country specific* (macro) political risks that are not directed at the firm, but are countrywide. He further distinguishes between *government risks* that stem from the governmental authority, and *instability risks* that stem from political power struggles. These distinctions are qualified with a number of variables for each as follows; government firm-specific risks (discriminatory regulations, *creeping* expropriation, and breach of contract), instability firm-specific risks (sabotage, kidnappings, and firm-specific boycotts), government country level risks (mass nationalisations, regulatory changes, and currency inconvertibility), and instability country level risks (mass labour strikes, urban rioting, and civil wars) (Berlin, 2003). These distinctions; firm-specific, country specific, government, and instability political risks, and the qualifying indicators will be taken into account when focusing on the relevant factors and indicators required for a political risk model specific to the oil and gas industry.

In order to assess the degree of political risk and to provide an accurate analysis, a number of variables need to be assessed. Berlin (2003) highlights the following indicators: the current activity in the host country that is affecting or is likely to affect the stability of the government (insurrection, rebellion, criminal activity); the prospect for change of national or local government; past history of nationalisation and expropriation; experience of other companies in the country; political activity and trends in the region; and the overall economic condition of the country. In terms of political stability, Berlin (2003) argues that the focus should be on the legitimacy of the state authority, highlighting the following indicators: the ability of that authority to impose and enforce decrees, the level of corruption that pervades the system of authority, and the degree of political fractionalisation that is present. In terms of economic policy, here the focus concerns indicators such as the degree of government participation in the economy, the government's external debt burden, and the degree to which interest groups can successfully obstruct the decision-making process (Berlin, 2003). These indicators are central to a political risk model specific to the oil and gas industry and will be considered for incorporation into the model developed in this study.

[75] For a full list of these macro and micro variables see Table 7: Political Risk Factors Affecting the Energy Sector, Appendix B

The model used and the conditions surrounding the particular investment affect the importance of the variables used in assessing political risk. Lax (1983, pp. 112-3) divides the key factors into three board divisions; host political risk variables, corporate political risk variables, and external/international political risk variables. He further divides host political risk variables into four subdivisions; governmental/political, economic, socio-cultural, and petroleum specific,[76] which include 38 indicators across three board categories of political risk, and is in no way ranked in order of importance but 'merely points in the direction of which variables may be important' (Lax, 1983, p. 113). As with the variables provided by Berlin (2003), the variables Lax (1983) presents will also be taken into consideration when developing the industry specific political risk model for the oil and gas industry, with some being incorporated.

3.4.4 Building a Political Risk Model (Methodology)

According to Lax (1983, pp. 113-4), 'It is the role of the model (...) to refine the list and organise the variables – their relationships, flows, and consequences, into a useful analytical tool.' Without a model, these variables only provide information, a framework is needed to organise the informational and put it to work for the analysis to be successful. There are simply too many variables to include all of them (some relevant, some less relevant, some irrelevant), in working with an industry specific model, the analyst must discard some variables, group others together, or treat some implicitly (Lax, 1983, p. 114). The variables discussed earlier in this section[77] are simply lists of indicators grouped under different headings, they are of interest, but they are nothing until they are structured into an analytical methodology. Lax (1983, pp. 120-1) argues that 'A method of analysis implies some model of the processes involved, even if the model is not formalised or explicitly presented,' arguing that:

> *'The methodology tells us how to analyse political risks. It is the key to structuring our thoughts, directing us toward important information, and organizing our procedures. The finished analysis is a product of the methodology. In a sense, methodology is our quality control: it ensures similarity in procedures and comparability of results.'*

It is important to point out that it is practically impossible to gather all the relevant information when undertaking a political risk analysis. It would take an immense amount of time to do so and the costs would be exorbitant. If the approach to a political risk analysis were as an information gathering exercise, the exercise would be ineffective and inefficient, and probably not yield the

[76] This list is presented in full in Table 8: Key Variables Relevant to the Oil and Gas Industry, Appendix B

[77] See further Table 7: Political Risk Factors Affecting the Energy Sector, Appendix B and Table 8: Key Variables Relevant to the Oil and Gas Industry, Appendix B for a tabular list of variables that may be included in the industry specific model.

desired analysis (Lax, 1983, p. 121). In creating a political risk model specific to the oil and gas industry, a methodological approach needs to be adopted and it is the aim of this research study to do so, selecting the most salient variables which can then be incorporated into a model that will yield realistic and practical results.

3.4.5 A Simplified Political Risk Model for Industry Specific Adaptation

In developing an industry specific risk model for the oil and gas industry, the foundation model laid out by Alon et al. (2006, p. 640) will serve as a basis for the model developed in this research study. According to these authors 'It is imperative for each company to conduct risk assessments, keeping in mind unique, industry specific micropolitical risks, while as the same time taking into consideration the general macropolitical risks' (Alon et al., 2006, p. 639). Alon et al. (2006, p. 639) provide a simplified political risk model[78] that 'can serve as a [model] that every company can start with in its endeavour to model a comprehensive political risk assessment strategy'. This simplified model ready for industry specific adaptation was developed by examining three specific sectors, including the energy sector, and an analysis was done of both BP and IHS.

By assigning a weight to each critical indicator, a reflection of each company's specific industry, operational location, risk tolerance, and general political-economic environment is achieved (Alon et al., 2006, p. 639). In this model, a score of between 0-10 is given for each indicator, with 0 representing *no risk* and 10 representing *maximum risk*. The scores are then multiplied by the percentage weighting, then added together to give a total for the country or region under examination. This score can be used as a comparison with other countries or regions that have undergone similar assessments using the same model. By adapting this base model, using the appropriate country, industry and project specific micro variables as well as general macro variables, a political risk model can be developed specific to the oil and gas industry (Alon et al., 2006, p. 639) which will be used in the analysis of the case study for this research study in chapter four.

The Alon et al. (2006) model is an effective starting point to build an industry specific risk model as it encompasses both macro and micro variables and it provides flexibility and adaptability to the investment. Indicators can easily be substituted as seen fit by analysts in order eradicate extraneous and erroneous information, or include necessary and vital information. This allows the model the scope to be relevant to the existence of country-specific or region-specific political risks, understanding that 'Each nation or region must be looked upon as a unique operating environment' (Alon et al., 2006, pp. 639-40). Alon et al. (2006, p. 40) further

[78] For the Alon et al. (2006) model, see Table 9: Macro/Micro Risk Analysis Using Critical Indicators, Appendix C

recommend that an assessment of this kind be undertaken at more than one level of a company, adapting the model in order to achieve a comprehensive political risk assessment at all levels of operations. These levels could include the corporate headquarters (macro assessment) through to regional headquarters (macro/micro assessment), down to individual operations within a region (micro assessment). In doing so, the company creates a corporate cultural awareness of political risk, which over time can be of great benefit to its operations. For the purpose of this research study, a regional level industry specific model will be developed which takes on board both macro and micro indicators, which emanate from both the internal and external dimensions. This represents the methodology of the political risk model specific to the oil and gas industry that will be developed in the flowing section.

3.5 A Political Risk Model for the Oil and Gas Industry

3.5.1 Defining the Model

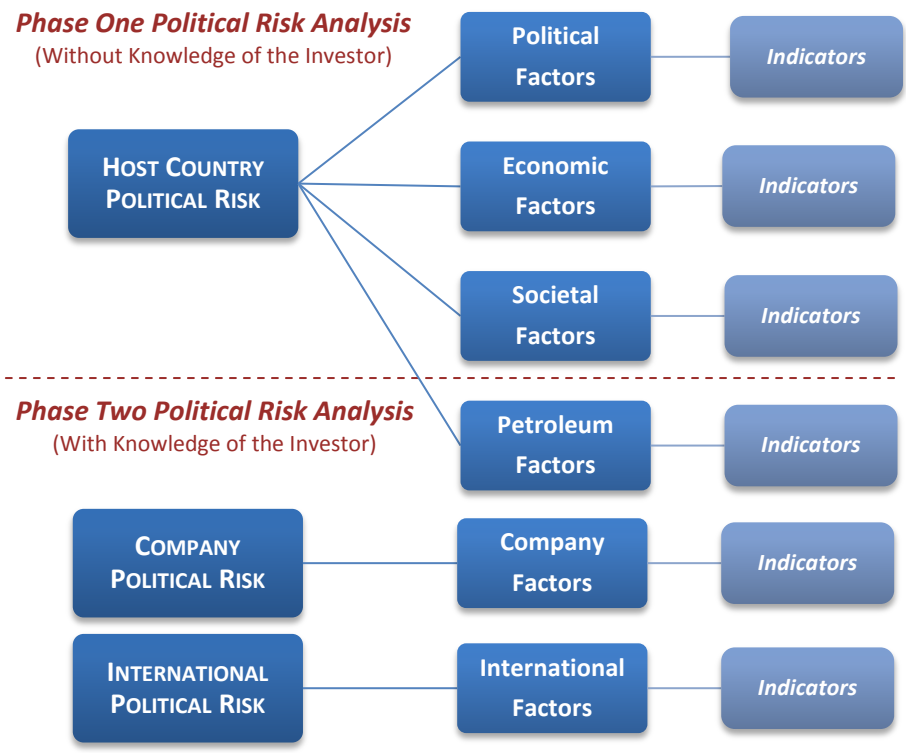


Figure 7: A Political Risk Model for the Oil and Gas Industry

Figure 7 is a graphical representation that provides a simplified look at the political risk model specific to the oil and gas industry developed in this research study. The model encompasses three types of political risk, *Host Country Political Risk*, *Company Political Risk*, and *International Political Risk*. *Host Country Political Risk* contains four core risk factors: *Political*, *Economic*, *Societal*, and *Petroleum*. *Company Political Risk* and *International Political Risk* contain a number

of factors which are too numerous to be shown in this simplified graphical representation, but will be listed later in this section.[79] For the purposes of this research study, macro and micro indicators have been identified for three of the core factors of *Host Country Political Risk*, as only a *phase one political risk analysis* will be undertaken in chapter four.

When conducting a political risk analysis specific to the oil and gas industry, the analyst either has knowledge of the investor or does not have knowledge of the investor. This changes the type of political risk analysis that can be undertaken considerably. For example, there are political risk analysts who can provide assessments on a number of investment opportunities in the oil and gas industry without knowledge of the investor. In this study, this is termed a *phase one political risk analysis*, and is characterised in the graphical representation above, separated from *a phase two political risk analysis*. Without knowledge of the investor, and hence the type of investment, political risk analysts cannot provide an assessment on the *Petroleum* Factors of *Host Country Political Risk*, *Company Political Risk* and the *International Political Risk* associated with the investment. With knowledge of the investor and therefore knowledge of the type of investment, the analyst can complete *phase two* of the political risk assessment. Here the *Petroleum* Factors of *Host Country Political Risk, Company Political Risk* and *International Political Risk* can add much greater depth to the analysis, having knowledge of the investor, the type of investment, and the home country.

The following sub-section will outline the three types of political risk, including the factors for each type as mentioned above. For the purposes of this research study, where there is no knowledge of the investor, a *phase one political risk analysis* will be undertaken, and thus only *Host Country Political Risk* will be analysed, focusing on three of the four core factors that form part of this category of political risk. More detail will be provided on these three factors (*Political*, *Economic* and *Societal*), including a division of the indicators into macro and micro categories, as they will be used for the *phase one* risk assessment in chapter four. Once the variables of both a *phase one* and *phase two political risk analysis* have been presented, the complete model associated with all variables will be made available, as well as the process involved in using this model and achieving a score and risk rating.

[79] See sub-sections 3.5.2 Host Country Political Risk (3.5.2.4 Petroleum (Phase Two), 3.5.3 Company Political Risk (Phase Two), 3.5.4 International Political Risk (Phase Two)

3.5.2 Host Country Political Risk

3.5.2.1 Political (Phase One)

Macro Indicators

- Regime/Political Stability: *Including the type of regime in power and the political system (military, authoritarian, one party state, multiparty state democratic)*
- War and Security Issues: *Including kidnapping, insurgency and terrorism, theft and pilferage, sabotage, and incidents of violence*
- Repatriation Restrictions
- Corruption/Poor Governance

Micro Indicators

- Unclear Legislation/Security of Tenure: *Including threat of adverse changes in contracts/fiscal terms, and changing royalty/tax regimes*
- Investment Constraints: *Including reserve requirements, restriction on the flow of funds, import/export concerns, and free trade zones*

3.5.2.2 Economic (Phase One)

Macro Indicators

- Economic Performance: *Including levels of growth in GDP capita, real GDP growth rate, and inflation (these indicators also assess the economic stability or instability of the host country)*
- Balance of Payments
- Credit Worthiness
- Currency Convertibility: *Including the foreign exchange position*

Micro Indicators

- Energy Vulnerability: *Including the importance of petroleum to the host government's revenues and the overall economy of the host nation, the integration between the oil and gas industry and the remainder of the national economy, and the role of foreign oil and gas companies in the domestic economy*
- Current Account Deficit
- Public/Private Sector Mix: *Including levels of privatisation*

3.5.2.3 Societal (Phase One)

Macro Indicators

- Internal Violence
- Civil and Labour Unrest

Micro Indicators

- Homogeneity: *Including ethno-linguistic/racial/national divisions*
- Ethnic Conflict

- Community Opposition/Social Licence to Operate
- Standard of Living
- Environmental Activism

3.5.2.4 Petroleum (Phase Two)

- Ownership
- Domestic Reserves/Production
- Host's Relative Market Position
- Level and Destination of Exports
- Strength of National Oil Company (NOC)
- Role of the Foreign Company in the National Oil Industry
- Oil and Gas Prices
- Domestic Ability to Operate the Industry: *Including the necessary skills, technology, know-how, and capital*
- Ownership/Contractual relationship between the Firm and the Host Country

3.5.3 Company Political Risk (Phase Two)

- Nationality of the Company
- World Industry Positioning: I*ncluding sources of crude, reserves, production, and market outlets*
- Special Bargaining Advantage: *Including* t*echnology, managerial skills, services, and capital*
- Host Government Relations: *Are they* r*eceptive, diplomatic, and open, or unreceptive, brusque, and unyielding*

3.5.4 International Political Risk (Phase Two)

- Host Government International Integration: *Including participation in international treaties, conventions and organisations*
- Host/Home Government Relations: *including the political/economic relationship between the host and the home government, encompassing security, trade, and aid issues*
- World Petroleum Market: *Including conditions relating to price, supply, and demand consumption*
- World Economic Condition: *Including current and projected levels of both economic growth and energy consumption*
- The Demonstration Effect: *Including developments in other oil-exporting countries*

3.5.5 Phase One and Two Political Risk Model: Practical Aspects of Using the Model

In the *phase one* and *phase two* political risk model represented in Table 1, each of the factors carries a percentage weight (of a total 100% combined). The analyst weights certain factors higher than others depending on the impact that factor has relative to the analysis and the other factors. In this process, a level of adaptability is achieved, which is essential in creating a successful political risk model. A score of between 0-5 is given for each of the factor indicators, based on the following index: 0-*No Risk*, 1-*Nominal Risk*, 2-*Low Risk*, 3-*Medium Risk*, 4-*High Risk*, and 5-*Extreme Risk*. The sum of each factor's indicators is added together to give a total score for the factor, which is then multiplied by the percentage weight assigned to that factor and then divided by the highest possible score of the factor (i.e. adding all the highest possible scores of the included indicators of a factor). When all the factors scores are added together, a final total score is achieved for the country or region under examination. The mathematical process for achieving the score for a single factor is represented by the following equation:

$$S_x = \frac{\sum_{I=1}^{n} R_I}{MTR}(W)$$

S_x = Score of Factor x
R_I = Ratings of Factor x
I = Indicator
W = Percentage Weight
MTR = Maximum Total Rating of Factor

By adding all the factor scores (S_x) together, the final score is achieved for the region or country under investigation. This score can then be compared against the scores attained by other countries or regions (using this model) for a comparative analogy, or against the *scale for investment and political risk indication*,[80] to determine the level of political risk associated with the country or region under assessment. Further, for the *phase one* aspects of the model, the analyst can utilise generic guidelines[81] that expand on the *scale for investment and political risk indication*. The *phase one guidelines* aim to give the analyst a general outline as to what to expect in the region under investigation in terms of the *security, investment, and political and economic situations*. In this process, the analyst can in a sense check the analysis to see if the information presented marries with the general guidelines associated with the score achieved. Although the full model (*phase one* and *phase two*) is presented here, the model that will be used in chapter four for the political risk analysis of the Ogaden will only use the *phase one* aspects, which will be presented there in detail. Therefore, more details regarding the *phase one* model are provided, such as the division of factor indicators into macro and micro categories and the guidelines for investors. This is largely to do with the limitations of the time and length requirements of this research study.

[80] See sub-section 3.5.6 Scale for Investment and Political Risk Indication, Table 2

[81] See sub-section 3.5.7 Phase One Guidelines: Security, Investment, Political and Economic Situations

Phase One and Phase Two Political Risk Model					
Type of Political Risk	Factors	Indicators	Rating	Weight	Score
Host Country Political Risk	Political	(cf. 3.5.2.1)	0-5	0-100%	
	Economic	(cf. 3.5.2.2)	0-5	0-100%	
	Societal	(cf. 3.5.2.3)	0-5	0-100%	
	Petroleum	(cf. 3.5.2.4)	0-5	0-100%	
Company Political Risk	Nationality of the Company	(cf. 3.5.3)	0-5	0-100%	
	World Industry Positioning	(cf. 3.5.3)	0-5	0-100%	
	Special Bargaining Advantage	(cf. 3.5.3)	0-5	0-100%	
	Host Government Relations	(cf. 3.5.3)	0-5	0-100%	
International Political Risk	Host Government International Integration	(cf. 3.5.4)	0-5	0-100%	
	Host/Home Government Relations	(cf. 3.5.4)	0-5	0-100%	
	World Petroleum Market	(cf. 3.5.4)	0-5	0-100%	
	World Economic Condition	(cf. 3.5.4)	0-5	0-100%	
	The Demonstration Effect	(cf. 3.5.4)	0-5	0-100%	
Total					0-100

Table 1: Phase One and Two Political Risk Model

3.5.6 Scale for Investment and Political Risk Indication

Scale for Investment and Political Risk Indication		
Score	Investment Indication	Political Risk Indication
0-10	Highly Advisable	Nominal
11-20	Advisable	
21-30	Very Low Risk	Low
31-40	Relatively Low Risk	
41-50	Low to Moderate Risk	Medium
51-60	Relatively Moderate Risk	
61-70	Moderate to High Risk	High
71-80	Relatively High Risk	
81-90	Unadvisable	Extreme
91-100	Highly Unadvisable	

Table 2: Scale for Investment and Political Risk Indication

3.5.7 Phase One Guidelines: Security, Investment, Political and Economic Situations

As a means to interpret the score generated by the *phase one* political risk model, the analyst may be in possession of guidelines that assists in understanding that score. Table 10: Guideline for Security Situation, Appendix D, Table 11: Guideline for Investment Situation, Appendix D,[82] and Table 12: Guideline for Political and Economic Situation, Appendix D are examples of such *phase one guidelines*. These *phase one guidelines* can provide the analyst and the investor with a general overview of what the score achieved in a *phase one political risk analysis* may mean in terms of the three different categories: *Security Situation* (including Safety, Terrorism, and Travel), *Investment Situation*, and the *Political and Economic Situation*. The areas covered concern the scores from 21-100, from low to extreme risk. These guidelines will be used when interpreting the score for the Ogaden in the *phase one political risk analysis* conducted in chapter four.

The guidelines for the scores achieved in the nominal risk range, from 0-20 are not presented as they are insignificant in terms of risk with virtually no risk at all, and investment is either advisable or highly advisable with such a low score achieved. However, it should be noted that even the most observably secure country or region is unlikely to return such a low score, as argued by Bremmer (2009) and quoted earlier in this chapter,[83] 'The current financial crisis has created an unprecedented space for government interference in economic affairs within developed states.' The 2007-2009 economic crisis has seen 'Unprecedented state interventions in those business sectors that had formed the true embodiment of apolitical free markets (banking, insurance, retail and manufacturing) may have somewhat re-defined political risk' (Multilateral Investment Guarantee Agency, 2008). Political risk is everywhere, and the possibility for any country achieving a score of less than 20 is highly unlikely.

3.6 Political Risk as a Decision-Making and Management Tool

In recent years there has been an increased number of headlines in the mining industry press which are not (as per usual) focused on actual mining or commodity prices, but rather on 'government action or inaction, [NGO] activity or problems with communities and other stakeholders' (Control Risks, 2009a). These issues deal with the complexities of managing above-surface political risks, which are unavoidable continuing challenges that the extraction industry faces. Investors in emerging markets are faced with doing business with 'new partners, in new parts of the world and in many cases, with new organisations and actors taking an interest [in the

[82] The Safety and Investment sections of Table 10 and Table 11 have been adapted from Control Risks' Political, Security, Terrorism, and Travel four star risk ratings.

[83] See section 3.2 Political Risk and the Global Environment

investments] (not always in a positive sense)' (Control Risks, 2009a). Issues such as these are certainly challenging for investors, but they can also be seen as opportunities, with a good understanding of the situation *on the ground*, to create an enduring value of the investment for the investor as well as the host community.

Oil and gas resources that are in countries with relatively low political risk or *safe* countries are increasingly more and more difficult to come by. This has resulted in the oil and gas industry looking to *unsafe* or higher political risk emerging markets to sustain supply. The need to move to these higher risk emerging markets has contributed to political risk and the analysis thereof becoming an integral part of both the decision-making (risk assessment) and management (risk mitigation) processes of the oil and gas industry. The best possible scenario is clearly to select the country or region that poses the least amount of political risk in order to gain the most out of the investment. Regions like the Ogaden, which would not even have been considered in the past, are now seen as viable investment opportunities. These regions are inherently risky because of their political and/or socio-economic situations, but they are also risky because they represent a completely new business environment for the investor. In order to achieve a successful entry into these new environments, the assessment and management of political and related aboveground risks is essential.

According to Wells and Gleason (1995), 'exposure to risk can vary between different projects, firms or product line', and that certain types of investments carry more risk when compared to others. They distinguish between three types of investment to show the level of political risk in relation to the type of investment. A build-own-operate (BOO) investment has the highest level of political risk as the ownership of the investment and the profits derived there from do not benefit the community where the investment is located. A build-operate-transfer (BOT) or a build-own-operate-transfer (BOOT) project has a lower level of political risk than a BOO as ultimately the investment will end up in the hands of the host country, and not its foreign investors (Wells & Gleason, 1995). Investments in the oil and gas industry are more commonly associated with the BOO type projects, where as infrastructure projects like electricity production, dams and ports, are usually of the BOT or BOOT type of projects. Thus, the oil and gas industry faces a higher level of political risk that requires them to seek an alternative means to give back to the community from whom they are extracting resources. It is often the case with BOO projects that the central governments of the countries benefit the most, with local communities directly affected by the BOO project receiving little if any benefit from the investment. At present, this appears to be the situation with the oil and gas in the Ogaden.

A brief look at the websites of the companies involved in political risk analysis shows just how much the focus on decision-making and management of political risk is part of the service that they provide. Exclusive Analysis[84] (2009b) states the following on their website under the Sector Expertise page titled Energy:

> *'In order to support decision-making about your operations (...) we deliver evidence based forecasts on political and violent risks. (...) We help clients identify risks and opportunities prior to entering a country or a deal, assess the likelihood and cost of business interruption to existing investments and assets, advise on capital re-investment & portfolio diversification and support on-going strategic planning and crisis management.'*

The websites of Eurasia Group and Control Risks, as well as others, all have similar statements highlighting the fact that political risk analysis is an effective and warranted decision-making tool, as well as a means to manage above ground risks within the oil and gas industry. It is imperative for investors in the oil and gas industry to view a political risk assessment as a value added component of their day-to-day operations.

3.6.1 Political Risk as a Decision-Making Tool / Risk Assessment (*Ex Ante*)

Assessing the political risk of an investment is of vital importance to the investor, it can be of use as a guide to investors when making choices about where to invest or whether to invest at all. What this research into the positions taken by oil and gas companies regarding political risk has revealed is that although the process is often *ex ante*, the decision to invest has already been made given the geological benefits and potential for profit of the investment. The political risk analysis that is undertaken prior to the investment going ahead is therefore more a precursor of the potential risks that will be part of the investment. The way in which an *ex ante* political risk assessment will be of value to the investor is in how it informs the way in which they move forward with the investment. This will be evidenced in the following sub-section, which shows the benefits of political risk analysis as a management tool, mitigating risk in an *ex post* manner, as seen later in the sub-section with the examples of Angola LNG and BP.[85]

3.6.2 Political Risk as a Management Tool / Risk Mitigation (*Ex Post*)

Once the investor is aware of the problems posed by political risk to the future or existing investment, the management of that problem can be undertaken in order to avoid losses and/or maximise profits (Brink, 2004, p. 30). According to Berlin (2003) 'Risk is a constantly present factor

[84] 'Exclusive Analysis is a specialist intelligence company that forecasts commercially relevant political and violent risks worldwide' (Exclusive Analysis, 2009a).

[85] See sub-section 3.6.3 Political Risk as a Management Tool in Practice: Angola LNG and BP

in business decision-making process, and determining appropriate ways to manage and mitigate risks is crucial to the ultimate success of any new investments or expansion of already existing business operations.' The management of political risk for investments in the oil and gas industry, which are often costly and time consuming, can take two different paths. Firstly, it can involve some form of political risk insurance, which is aimed at 'assuring the investor that compensation will be received for all or part of the investment if a loss does occur' (Berlin, 2003). Secondly, management can take the form of *de facto* insurance which involves a strategic partnership and/or planning 'aimed at trying to prevent a loss from occurring in the first place' (Berlin, 2003).

Further, it is necessary to understand that the process of analysing political risk is an ongoing one and needs to be constantly adapted to changes *on the ground*. Undertaking a political risk analysis that identifies possible problems is only an analysis (it is not the solution to the problems that may occur), and persistent work needs to be done in order to assure the continued profitability of the investment. In the case of firm-specific political risk, the investor can protect themself from possible forms of political risk by 'incorporating strong arbitration language into a contract or by enhancing onsite security' (Berlin, 2003). Whichever path the investor chooses, undertaking a political risk analysis, and taking onboard the suggestions and recommendations of the analyst, provides the investor with vital and valuable insights into the continued profitability of the investment.

Due to increased pressure from NGOs, there has been a change in strategy from Western oil companies regarding their investments in emerging markets, particular Africa. They have begun to improve their behaviour in terms of their interaction with the communities from which they extract resources. However, the economic growth of countries like China and India, as well as the stabilising of the Russian oil and gas industry, has seen an increase in activity from these three countries in terms of investments in the oil and gas industries of emerging markets. Western oil companies 'now face competition from Chinese, Indian, and Russian rivals that seem willing to cut deals with even the most unsavoury African politicians' (Economist, 2006). These deals have meant that those who wish to conduct business in the international oil and gas industry, have to deliver better proposals to the communities and countries they wish to extract resources from.

Any successful management of political risk and the mitigation thereof will involve some form of engagement with local stakeholders. This could take the form of integrative and protective techniques, which are aimed at 'reducing the impact political risk might have on a foreign firm' (Brink, 2004, p. 156). Integrative techniques aim to integrate the investment and the host country by influencing relations with stakeholders in the political environment, thus the

investment is perceived to be less foreign, with the goal of reducing the frequency of loss. An example of an integrative technique could be partaking of a JV with the host country's government.

Protective techniques aim 'to discourage host government interference, or in the event of interference, minimize the firm's potential losses and generally provide for the non-integration of the foreign operation into the host country' (Brink, 2004, p. 156). The goal of protective techniques is to reduce the severity of loss while protecting the key internal strengths of the investor (Brink, 2004, p. 156). An example of a protective technique could be withholding any technological expertise or advantage from the host country. These integrative and protective techniques should from part of the investors risk management strategy. Through integrative techniques, the investors will be able 'to respond to both the demands of a host country's political environment and the opportunities that the environment presents, while protective techniques offer a means to secure competitive advantage' (Brink, 2004, p. 156).

Community relations strategies should be creative in their outlook and involve a high degree of local community participation in projects. These projects should extend beyond simply financial incentives to a more genuine form of community interaction with extensive local consultation. Strategies need to be developed as well as policies and procedures for employees to engage productively with the community, NGOs, and the media at local levels. In doing so companies are able to elevate themselves above others in becoming well versed in all the aspects of the political risk involved in the investment, be they traditional or new. Having such an understanding of the environment and the political risk faced, the investor is able to make sophisticated, informed, and rational decisions about the political risk associated with the investment, as well as manage the implementation of value-creating risk management programmes. If strategies such as this are adopted, investors can pursue opportunities in most parts of the world, and consequently, create substantial and enduring value for shareholders (Control Risks, 2009a).

Table 3 provides a summary of the recommendations for investors concerning the options available for political risk management and mitigation mentioned in this sub-section.

Tools to Deal with Political Risk, including Limitations			
Tool	**What is it?**	**Application**	**Limitations**
Political Risk Insurance	Insurance policy offered by major insurers usually covering "traditional" political risks – expropriation, currency inconvertibility, war, etc.	• Assure lenders or shareholders, • Transfer some state-level political risks	• Merely a safety net, not a solution • Can be expensive • Many policies do not cover more common sub-sovereign level (e.g. local government, NGO) political risks
Portfolio Diversification	Diversify projects in variety of jurisdictions in order to spread risks	• Spread possible projects across countries and regions in order to minimise impacts of potential political risks	• Does not address the actual political risks themselves • Limits opportunities
JV Partners	Choose JV partners on basis of being able to leverage their political connections, understanding	• Minimise likelihood and impact of political risks by aligning interests with those of key local partners	• Can become liabilities with regime change • Can use political influence against investors
"Prominent Victims"	Include members in consortia that are important to host government (e.g. World Bank, major aid provider)	• Minimise likelihood of political risks by working with a stakeholder that is important to the host government	• Interests may not completely align with investor • Presupposes "rational" host government
Lobbying and Employment of Well-Connected Country Expert	Influence policy and regulatory environment through Embassies, other bodies, ex-diplomats, ex-ministers, etc.	• Help shape policy environment to suit one's interests; obtain preferential access to host government	• Lack of control; dependent on many externalities • Interests may not align hard to measure
Security Management	Manage political (and security) risks at operational levels; protect assets; manage threat levels	• Minimise impact of political risks to people and assets	• Protective measure mostly • Limited ability to address root causes of risks
Corporate Social Responsibility and Stakeholder Management	Obtain and improve levels of support for project by creating strategic partnerships with local communities and other stakeholders	• Obtain and maintain one's social license to operate, minimise political risk (reputation and security risk)	• Requires careful planning and significant management time to ensure a project-specific approach • Planning mistakes can augment political risks

Table 3: Tools to Deal with Political Risk, including Limitations [86]

[86] Adapted from Control Risk, 2009a

3.6.3 Political Risk as a Management Tool in Practice: Angola LNG and BP

The following sub-section focuses on two examples that highlight the significant benefits of political risk management and mitigation, both *ex ante* and *ex post*. Unlike the *phase one political risk analysis* that will be undertaken in the following chapter, the examples of Angola LNG and BP provide real world data and evidence of successes that can be attributed to the benefits of a complete political risk assessment (both *phase one* and *phase two*). These examples provide much-needed insights into the process of political risk management and mitigation in practice, and only strengthen the case for the relevance political risk as a field of study.

3.6.3.1 Angola LNG

In a recent article titled *Doing Business in a Volatile World*, Duncan Wood (2009) poses the question: 'Have you heard about the turtle that moved the power plant?' The answer to this riddle provides a clear example of the benefits of political risk analysis to the oil and gas industry, with the successful management of 'the political risks associated with the construction of a huge, multibillion-dollar liquid natural gas (LNG) facility near the mouth of the Congo in Angola' (Wood, 2009). Angola, as show in chapter one,[87] has vast oil and gas resources, but it is also a poor country still emerging from the after effects of a civil war. With this in mind, Chevron,[88] Angola LNG's biggest stakeholder,[89] made the decision to build a good relationship with both the central and local government, NGOs, local communities, and traditional leaders in Angola. In total, over 200 meetings were held with these various stakeholders prior to a fully formed plan being established for the plant. As Laurentino M Silva, the Angola LNG manager of local issues and government relations, and a local himself, stated 'We wanted to be welcomed by the local community, so we reached out and asked what was important to them' (Wood, 2009).

The answer to that question is the answer to the riddle, the people wanted the habitat of local marine turtles to be preserved, and as a result, the plant was moved to a different part of the bay. In addition to the turtles, the local communities were worried about the annual whale migration; how the operation of the plant might interfere with this process and affect the whales, which are of religions significance to them. The answer from Angola LNG was to offer to cease operations during the migrations, which was welcomed and accepted by the people. The people also asked for an upgrade to the local village, 'if the company was going to build a new village to

[87] See section 1.3 Research Problem

[88] Chevron are the ' Second-largest integrated energy company in the United States and among the largest corporations in the world (...) [with] Business activities in more than 100 countries' (Chevron, 2009).

[89] Chevron hold a 36.4% stake in Angola LNG, with BP, Total, ENI and the state-owned Angolan energy company Sonagol, making up the remaining investors (Wood, 2009).

house construction workers, then why shouldn't the existing village get an upgrade?' (Wood, 2009). The answer from Angola LNG was positive, agreeing to the request. The final request from the local community was free gas for the village, and Angola LNG obliged. Along with the upgrades to the villages, Chevron sent their own engineers in to do the work, hiring some local crews, 'making friends and building goodwill in the process' (Wood, 2009).

The net result of these four requests did incur additional charges, 'so much so that one partner, ExxonMobil,[90] pulled out' (Wood, 2009), but according to Witold Henisz, Associate Professor of Management at the University of Pennsylvania's Wharton School, 'Chevron's decisions were shrewdly commercial' (Wood, 2009). Henisz (Wood, 2009) argues that:

> *'This was all based on a cost-benefit analysis, which included the often ignored benefits of political and social capital.* [Angola LNG] *recognised that these concessions were going to increase the net present value of the project, and so far, they have been right: the project has made every building permit, every construction deadline and is on track to go online as scheduled. That's really quite unusual.'*

The Angola LNG operation is a long-term one, what better way to start a long to relationship than with goodwill and good intentions, no matter how shrewd the underlying reasons might be. The extra expense to investors has been well worth it and they regard the process as a critical success. This is clear evidence of the benefits of understanding all aspects of the political risk of an investment before it is made, and working to manage and mitigate those risks. Political risk analysis is more than simply providing a report with risk rating tagged to the end of it, it is now a fully integrated part of the investment, and essential to an investments' continued success and profitability.

3.6.3.2 BP

What is known of BP's strategy toward political risk has been developed in terms of their operational security, and 'Successfully managing political risk is the major political risk associated with BP's operations' (Alon et al., 2006, p. 633). Since the early 1990s, 'a number of countries have been open to foreign oil and gas companies that had been closed for decades' (Knott, 1997, p. 31) and during this time BP made field investments in Colombia, Algeria, and Azerbaijan. These three countries had at that time a level of instability that represented a security concern for BP and its operations in these countries. However, these levels of instability have not deterred BP from maintaining its upstream and downstream operations, or from looking to other newly

[90] ExxonMobil is 'the world's largest publicly traded international oil and gas company (...) [they] operate facilities or market products in most of the world's countries and explore for oil and natural gas on six continents' (ExxonMobil, 2009).

opened markets for profitable investments. This is largely due to BP's approach to its security, which is in effect a form of political risk mitigation. According to Knott (1997, p. 32), 'BP has a well-established strategy for dealing with security, which allows a range of approaches to fit different ways of working in various countries and with a spectrum of political regimes.'

From an examination of BP organisational security, it is possible to establish that their approach to political risk is one of management and thus mitigation. At every level within the company's structure, be it corporate, regional, or country headquarters, right down to the operation locations, security is a concern; with each level managing their own security. In this sense what is undertaken at BP corporate in London is a macro analysis of the risks the company faces, and what is undertaken at the field operation in Cusiana is a micro analysis of the risks that asset faces. Thus from London to Cusiana, examining risk is part of the cultural of BP and underpins its organisation. As Tony Ling (BP's regional security adviser for the Far and Middle East during the 1990s) states 'If a business asks for a security review when a project is only a twinkle in a manager's eye, this is the surest indicator of our success. It means that security is been seen as part of the operational process' (Knott, 1997, p. 33). Ling alludes to BP's approach to political risk, in that it is an *ex ante* and *ex post* investment activity and one that is continuous, concluding that 'There are very few countries in which an oil company cannot operate. Most risk is manageable, but cannot be eliminated completely' (Knott, 1997, p. 33).

This analysis of BP's position toward political risk reveals how important the management and mitigation aspects of political risk are. The focus of their position towards major political risks associated with their operations is that of successfully managing political risk. BP has measures in place to deal with volatile situations that might arise in their operations in foreign countries. Their internal security system is active and ready to deal with the political risk the company faces. This internal security system draws from 'specialists from different areas of security including a police force, army, foreign offices, and even civilians' (Alon et al., 2006, p. 633). In addition to its internal security services, BP's external strategy is to outsource some of its security by recruiting low-level guards from the local security firms, as well as 'maintaining good relationships with local government agencies' (Alon et al., 2006, pp. 633-4). BP's focus on management and mitigation of political risk is indicative of, as Alon et al. (2006, p. 626) argue, 'The decline in nationalisation [which] has subsequently led to a corporate shift from forecasting toward managing risk.'

3.6.4 Comparing Approaches: BP, IHS, and Control Risks

Table 4 provides a comparison of three of the companies examined in this research study, BP, IHS, and Control Risks, and their approaches to political risk as a decision-making tool / risk

assessment (*ex ante*) and political risk as a management tool / risk mitigation (*ex post*). It shows how each company defines political risk, how they assess/manage political risk, whether the risk is *ex ante* or *ex post* FDI, and finally how the risk assessment is used by the company.

Comparison of Risk Assessment and Risk Mitigation			
Questions	**BP**	**IHS**	**Control Risks**
How Political Risk is Defined?	Defined as security and the potential for political instability. Political risk is an inherent industry characteristic and must be managed continuously and profitably.	Three major risk factors; Political, Economic, and Commercial Petroleum risk – subdivided into 11 variables.	Defined in terms of traditional (government actions) and non-traditional (local/regional actors). Four key risk factors: Politics and Governance, Security, Reputation and Social Issues, and Infrastructure and Health.
How Political Risk is Assessed?	Close ties with local government yields intelligence. Furthermore, in some cases, BP outsourcers its risk assessment/management functions.	11 Variables are ranked from 1-5. The weights indicate the variables relative importance and its capacity to affect a country's petroleum environment for good or ill.	16 indictors covering the four key risk factors, specifically related to the broader extraction industry. Many of these variables are inter-related and "mid-tier" risks.
Is Risk assessment *ex ante* or ex *post* Investment?	Both and continuous, there are very few countries in which an oil company cannot operate. Most risk is manageable, but it cannot be eliminated completely.	Both *ex ante* and *ex post*. Oil companies are able and willing to work in almost any country in the world. Therefore, assessment is largely *ex ante* to inform ongoing operations.	Both, given that political risk can stem from local governments, international and local NGOs, community groups, local competitors or any other group advancing political objectives.
How is a Political Risk Assessment Used?	Line managers and contractors are responsible for security. Used for contingency planning.	Risk management is largely *ex ante*: identifying concerns needing to be addressed going forward.	Essentially as part of the decision-making process, but also continuous *ex post*.

Table 4: Comparison of Risk Assessment and Risk Mitigation [91]

This comparison answers a number of questions by looking at each company and examining their position on these specific issues. These questions include; how political risk is defined, how political risk is assessed, is risk assessment *ex ante* or *ex post* investment, and how is political risk assessment used? Along with the Angola LNG example, these provide the overwhelming response

[91] Adapted from Alon et al. (2006, p. 638) and expanded to include informtaion from Control Risks (2009).

that political risk, and the analysis thereof, is both an *ex ante* and *ex post* activity, which is of vital important to the investor and the investment.

3.7 Conclusion

The focus of this chapter has been on industry specific political risk analysis and the practical or *on the ground* application of political risk. The objective here was to develop a framework based on the underlying theory of political risk set out in chapter two by disseminating the literature concerning the practical application of political risk and the analysis thereof. This provided the necessary foundation to develop an industry specific political risk model for the oil and gas industry. This was further enhanced through an analysis of political risk and it relationship firstly to the global environment, secondly to the oil and gas industry, and finally in relation to industry specific political risk analysis. Factors and indicators relevant to the oil and gas industry were discussed, as well as the methodology behind building a political risk model for analysis, before the political risk model specific to the oil and gas industry was presented. The chapter concluded with a look at the political risk analysis as a decision-making tool (risk assessment), as well as a means to manage the political risk associated with an investment (risk mitigation).

Chapter four will focus on the application of the model developed here, to the case study of the oil and gas industry in the Ogaden. This chapter will also include some background on the geographic location of the Somali Regional State and the Ogaden, as well as information regarding the oil and gas sector in the Ogaden Basin, in terms of the potential for reserves in the region. A *phase one political risk analysis* will be presented using the factors and indicators selected for incorporation into the model developed in this chapter. By using an industry specific political risk model, the risk analysis conducted in chapter four will be more precise and accurate, and therefore the risk evaluation for investors will be more relevant. The political risk assessment on the Ogaden will conclude with recommendations to current and future investors in the oil and gas industry there, including aspects of risk management.

CHAPTER FOUR: A POLITICAL RISK ANALYSIS OF OIL AND GAS INVESTMENTS IN THE OGADEN

4.1 Introduction

The following chapter focuses on the application of the industry specific political risk model developed in chapter three to the case study, the oil and gas industry in the Ogaden. A *phase one political risk analysis* will be undertaken as part of the political risk assessment of the Ogaden. This can aid both current and potential investors as a decision-making tool (risk assessment) and will include recommendations that will aid them as a management tool (risk mitigation). The reason for the use of a *phase one risk political risk analysis* and not a complete *phase one and two political risk analysis*, is simply that there is no knowledge here of the investor. As mentioned in the previous chapter,[92] when conducting a political risk analysis; either the analyst has knowledge of the investor or they do not. This knowledge is crucial in undertaking a full political risk assessment that would benefit the investor and the investment in a more detailed specific way. Thus, without the knowledge of the investor, the type, and purpose of the political risk analysis that can be undertaken changes somewhat.

What is presented here is a general political risk assessment of a more preliminary nature, although still micro in scope, focusing on the oil and gas industry in a specific region. This assessment would therefore accompany other reports on regions similar to it, and could be presented to investors, who at the preliminary stage of an investment, are looking for options and assistance in moving forward with an investment. Once this has been decided upon, the investor could then commission a full *phase one* and *phase two political risk analysis*, which would provide the additional aspects of the investor, as well as the home country where the investor is located and other international factors. This knowledge therefore allows the analyst to take onboard a considerable number of variables which are absent in a *phase one political risk analysis*.[93] This does not mean that a *phase one political risk analysis* lacks value in assisting the investor in the decision-making process. It is a vital step in this process, one that has the ability to present a variety of investment options to the investor, providing crucial information at an early stage in the decision-making process.

Another benefit to a *phase one political risk analysis* is that reports can be issued on short notice, with a relatively quick turnaround time. These reports can be archived and constantly updated by the analyst at regular intervals, making them easily accessible and readily available to

[92] See sub-section 3.5.1 Defining the Model

[93] See sub-sections 3.5.2.4 Petroleum (Phase Two), 3.5.3 Company Political Risk (Phase Two), and 3.5.4 International Political Risk (Phase Two)

investors. Additionally, *phase one* reports form the foundation of a complete political risk assessment for the investor. Within the field of political risk analysis, this separation of *phase one* and *phase two political risk analysis* allows for specialisation, whereby certain analysts would focus on either *phase one* or *phase two*. *Phase two* could further be split in two sub-divisions, with some analysts focusing on the corporate aspects (*Company Political Risk*) of the analysis, while others focus on the international aspects (*International Political Risk*) of the investment. Each part of the analysis plays an important role in the process of decision-making and risk management, which is a multi-tiered and complex procedure that should be fully incorporated by the investor into their overall investment strategies.

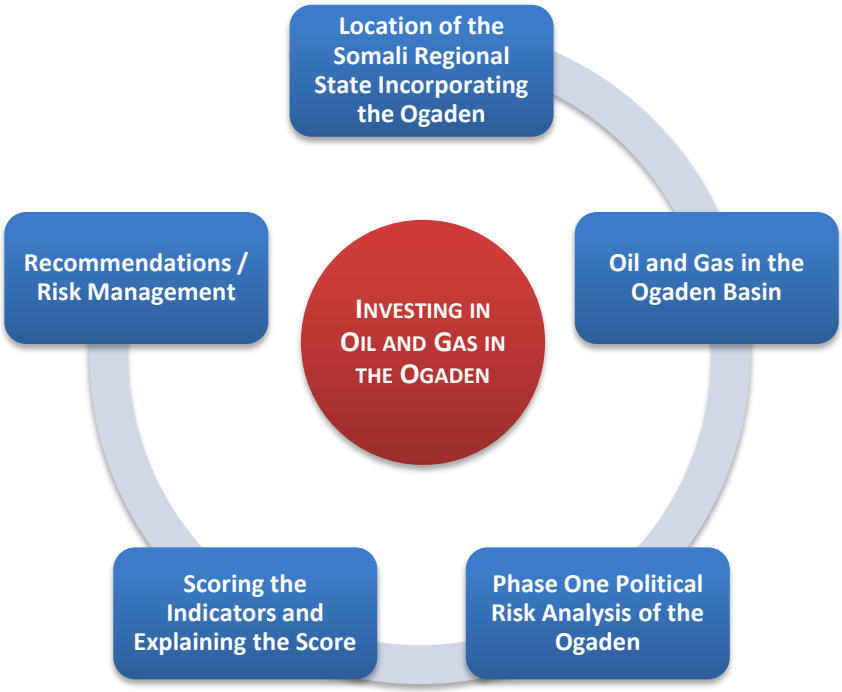


Figure 8: Phase One Political Risk Assessment

Figure 8 shows the path this chapter will follow. This *phase one political risk analysis* will take the form of a commission by an investor, or as a report, that forms part of the archives of a political risk firm under their oil and gas or energy divisions. It will vary slightly from traditional reports of this type in that it will contain explanatory and descriptive notes on the process of political risk analysis, and refer to prior chapters, sections, and sub-section of this research study. The analysis will begin with a look at the geographical region under investigation and the status of the oil and gas industry in that region. This will be followed by the *phase one political risk analysis* using the factors; *political*, *economic*, and *societal*, and the scoring of the 20 indicators that underlie these three factors, as per the political risk model developed in chapter three. This total score will be evaluated, and in the absence of scores from other regions generated using the same model, the

score will be explained in terms of the *scale for investment and political risk indication*[94] and the *phase one guidelines* for the *security, investment, political and economic situations*.[95] The chapter will conclude with a section on the recommendations to the investor regarding the region under investigation, specifically regarding political risk as a management tool (risk mitigation).

4.2 Location of the Somali Regional State incorporating the Ogaden

The Somali region of Ethiopia, which incorporates the Ogaden, occupies a large geographical area in the eastern part of the country designated as one of the nine ethnic federal states, officially termed the Somali Regional State.[96] The state lies between latitude 4º and 11º north and longitude 48º east, and the area of the state is estimated to be 340,000 square kilometres. The Somali Regional State is bounded by Kenya and Somalia to the south, with Djibouti and the Ethiopian Afar region to the north. As well as dominating the southern boarder, Somalia also flanks the eastern boarder of the Somali Regional State, with the Ethiopian region Oromiya to the West. The Somali Regional State is divided into nine administrative Zones, which are comprised of 54 Weredas, which make up the Zones. In terms of climate and vegetation, the region is described as arid and semi-arid (Gebre-Mariam, 2005, p. 11).

The rainfall in the region, a key factor in the livelihood of the largely rural agriculturally subsistent-based population, is low, erratic, and unreliable. With 300-500mm annual rainfall, the region frequently faces droughts that can cause shortages of food and water for both humans and livestock (Gebre-Mariam, 2005, p. 11). The area that comprises the Ogaden region of the Somali Regional State is approximately 240,000 square kilometres, containing open grassland used for cultivation and 'is the favoured grazing land within the Somali Regional State and in the wider region' (Gebre-Mariam, 2005, p. 12). The average annual rainfall in this region of the state is typically 350mm or less (Gebre-Mariam, 2005, p. 12). Rainfall is crucial to the region as the Ogaden is almost completely dependant on agricultural, which if jeopardised, could easily result in loss of livelihood, which in turn could transform into civil unrest and conflict.

[94] See sub-section 3.5.6 Scale for Investment and Political Risk Indication, Table 2

[95] See sub-section 3.5.7 Phase One Guidelines: Security, Investment, Political and Economic Situations

[96] See Map 1: Ethiopia (including the Somali Regional State and Surrounding Countries) and Map 2: Somali Regional State in section 2.4 Contextualisation: Background to the Conflict in the Ogaden

4.3 Oil and Gas in the Ogaden Basin

Map 3[97] shows the 21 blocks available for oil and gas exploration in Ethiopian, which encompass the entire region known as the Ogaden Basin, which as shown forms part of the Somali Regional State.

Map 3: The 21 Block Concessions in the Ogaden Basin

The potential for oil and gas reserves in Ethiopia lies in these 21 blocks in the Ogaden Basin region in the eastern part of the country. In 2003, the rights to explore some of these blocks were awarded on a concession basis to companies from the Netherlands, Malaysia, Sweden, Hong Kong, the US and others. This region forms the majority part of the Somali Regional State, however, the control over the awarding of concessions and thus the explorations and drilling rights has come from the central government authority in Addis Ababa, and the region has little control over its potential oil and gas resources. The geological qualities of the Ogaden Basin make the region similar to that of other hydrocarbon basins that have yielded substantial returns to investors in recent decades, specifically those in the Middle East (Sudan Vision, 2003). Currently it is thought that the Oagden may hold significant reserves of crude oil and natural gas across an area which is formed of sedimentary rock up 10,000 meters thick (somaliawatch.org, 2002). This is the equivalent size to 240 North Sea blocks, 'for scale of reference, an area this size in the North Sea has over 50 oil fields with over 500 exploration wells drilled' (Africa Oil Corp., 2009).

According to Africa Oil Corporation[98] (2009) which has exploration rights in Blocks 2, 6, 7, and 8 in the Ogaden Basin, exploration activity in the basin is escalating, 'but this section of the

[97] Adapted from the Ethiopian Ministry of Mines and Energy, 2009

East African rift system remains extensively under explored.' As of May 2009, exploration discoveries have proven the existence of over four trillion cubic feet of gas with 'several wells recovering significant amounts of good quality light oil' (Africa Oil Corp., 2009). However, to date, no oil production is under way in the Ogaden and investment in the region has been of an exploratory nature only (Ethiopian Ministry of Mines and Energy, 2009). Despite the rights being awarded to these companies, the question exists whether profitable operations are feasible because of the ongoing conflict in the region. This conflict has increased the political instability of the Ogaden, and thus the political risk for investors in the oil and gas industry there.

Investments in the extraction industry can exceed US$1 billion and take many years to complete, thus it is costly and time consuming effort. The efforts of Petronas in the Ogaden Basin have cost the company upwards of US$200 million in total on acquiring block concessions and exploration costs of those blocks (The Reporter, 2009). This is dwarfed by the US$3 billion Petronas have committed to 'gas development activities in the Ogaden Basin' (SouthWest Energy, 2009), which includes a major gas pipeline in the region. Thus, it requires a considerable commitment from the investing companies, both in terms of finances and personnel needed to accomplish the desired outcomes. It is of paramount importance to companies that they are aware of as much as possible of the situation in the territory they are investing in, particularly so in politically unstable regions. Investors cannot simply take the words of government ministers and officials as being anything more than political posturing and rhetoric designed to enhance the country's FDI opportunities.

4.4 Phase One Political Risk Analysis of the Ogaden

Typically political risk in not within the control of the investor and thus the level or degree of political risk must be determined prior to an investment taking place. Ultimately, the decision to invest or not is one of profit versus risk, it is a decision which is also affected by the market and other variables. The factors and indicators used in this political risk assessment will cover only those found under the category of *Host Political Risk*, excluding the factor of *Petroleum*, which requires knowledge of the investor. These factors can be found in the previous chapter[99] and they form the basis of the *phase one* component of the political risk model for the oil and gas industry developed in this research study.[100] Where relevant and possible all indicators will relate

[98] Africa Oil Corporation is a division of Lundin East Africa, a Swedish oil company with offices in Calgary and Vancouver (Africa Oil Corp., 2009).

[99] See sub-sections 3.5.2.1 Political (Phase One), 3.5.2.2 Economic (Phase One), and 3.5.2.3 Societal (Phase One)

[100] See sub-section 3.5.5 Phase One and Two Political Risk Model: Practical Aspects of Using the Model

specifically to the Ogaden, while the remainder will relate to Ethiopia and the central role the Ethiopian government plays in determining certain indicators, for example the balance of payments. The indicators will be discussed collectively in terms of each factor and the scores shall then be attributed to the indicators represented in the sub-section containing the model.[101]

4.4.1 Political

This sub-section will discuss issues pertaining to the following indicators; Regime/Political Stability, War and Security, Repatriation Restrictions, Corruption/Poor Governance, Unclear Legislation/Security of Tenure, and Investment Constraints, and conclude with a rating that indicates the current level of *Political* (factor) risk.

Meles Zenawi, 'a champion of the free market and parliamentary democracy' (BBC News, 2009), was re-elected in May 2005 as prime minister in bitterly disputed elections, this began his third term in office having won the 2001 and 1995 elections. Meles has effectively been in power since 1991, when his EPRDF's rebel group advanced on Addis Ababa overthrowing the countries ruling part, the Dergue (Fund for Peace, 2009b). He is one of the architects of the 1994 constitution that provided for a federal republic with ethnically based regions, transforming what was once a highly centralised system to one of ethnic federalism. Although this decentralisation has occurred, a number of challenges remain (World Bank, 2009). Ethiopia is a multiparty democracy although this has only been the case for the previous two elections. The government have used force on occasion to quell opposition voices, as occurred in the aftermath of the 2005 elections, where opposition supporters took to the streets in protest at what they felt were unfair corrupt elections. This resulted in clashes between the government and the opposition supporters, leaving 36 dead and hundreds arrested; a further 46 people were killed in November 2005 from opposition protest related incidents (BBC News, 2009). In the Somali Regional State, local elections were not held in 2008, and the '2010 elections are unlikely to offer voters a genuine political choice given the repression since 2007' (International Crisis Group, 2009, p. 28).

Some commentators have argued in light of these events, that a 'campaign against political decent was underway' (BBC News, 2009) and Meles accused the opposition of trying to topple his government. The BBC (2009) reported that 'Senior opposition figures and journalists were among those detained and charged with treason in the wake of the 2005 protests,' in response to these actions a number of Western donors suspended aid to the country. 'In July 2007, the International Committee of the Red Cross (ICRC) had to close its Godey and Jijiga offices after the army accused it of supporting the ONLF' (International Crisis Group, 2009, p. 35). This

[101] See section 4.5 Applying the Model and Scoring the Indicators

order from the Ethiopian government for the removal of the ICRC occurred in the aftermath of an incident involving an oil exploration team, which lead to violent clashes between Addis Ababa and the ONLF (Ryu, 2007). According to the World Bank (2009), 'The national elections in 2005 and the largely uncontested local elections in April 2008 illustrate the fragility of the democratic transition, the dominance of the EPRDF, and the weakened state of the opposition.' The next round of elections is scheduled for 2010 and is expected to draw much attention internationally and domestically. In January 2009, the Parliament in Ethiopia passed legislation to regulate Civil Society Organisations (CSOs), the new law is seen as quite restrictive in demarcating areas of operations for different types of CSOs' (World Bank, 2009).

At present, the state controls the majority of the radio stations in Ethiopia, which is the main form of media communication in the country, covering the rural areas where most of the Ethiopian population are prevalent. In 2006, licences were awarded for two private radio stations broadcasting within the capital, Addis Ababa. There is a single national network television station that is also under state control (BBC News, 2009). Since 1994, and the overthrow of the Mengistu regime, the broadcast media has seen substantial reform, and the print media has seen an increase in the number of privately owned newspapers, including those available online. These non-state controlled forms of media are often heavily critical of the government and have differing opinions to those of the state controlled media. It was reported by the BBC (2009) that the 'Media rights group Reporters Without Borders cited a "spiral of repression" against the private media after violent protests following the 2005 elections (...) [and that] The climate remains bad and self-censorship frequent.' Voice of America (VOA) and Deutsche Welle reported that their 'broadcasts were intermittently jammed in late 2007, and in June 2009, the government ordered the local Sheger FM radio station to stop re-broadcasting [VOA content]' (International Crisis Group, 2009, p. 21).

War and security issues have plagued Ethiopia for many years and following the overthrow of the Mengistu regime, the situation remained the same. A number of instances involving neighbouring countries Eritrea and Somali have continued to dominate the agenda. This included a border dispute with Eritrea,[102] which escalated into a full-scale war in 1999, these border tensions persist today. In terms of Somalia, Ethiopian troops have at times been active in that country, for example assisting Somali troops in ousting the Islamists who controlled the southern region of the country for six months in 2006. Ethiopia's presence in Somalia only ended

[102] Eritrea gained independence from Ethiopia in 1993 following a referendum, however poor border demarcation has been a significant problem in the creation of this new state (BBC News, 2009).

in early 2009 ‘when it pulled its troops under an agreement between the transitional Somali Government and moderate Islamists (BBC News, 2009).

4.4.1.1 The Petronas Incident

A major incident concerning the oil and gas industry and thus the *Political* risk of the Ogaden took place on 24 April 2007. Exactly one year prior to the incident, the ONLF issued a statement warning foreign oil companies against exploration in the region, which they consider their homeland. The statement contained the following key sentence, ‘So long as the Somali people of Ogaden are denied their basic rights to self-determination, the exploitation of natural resources in Ogaden for the benefit of the Ethiopian regime or any foreign firm will not be tolerated’ (Leonard, 2007). One year later to the day, they took credit for the killing of 74 people (65 Ethiopians and nine Chinese nationals) and the kidnapping of a further seven workers (all Chinese) at an oil exploration field in the northern region of the Ogaden (Bekele, 2009).

The incident occurred at the site of Malaysia’s Petronas operated concession, where a sub-contract had been awarded to Sinopec, a Chinese state run oil and gas company, who had ordered one of their subsidiaries, the Zhongyuan Petroleum Exploration Bureau (ZPEB), to undertake exploratory work at the site (Bekele, 2009). The oil exploration facility at Abole near Obala in the Degehabur Zone of the Somali Regional State was destroyed, halting the seismic survey and drilling of exploration wells. The project was part of the activities ZEPB were contracted to undertake and cost Petronas an estimated US$32 million in sunk costs (Leonard, 2007). In the days following the attack, ZEPB evacuated all its employees working at all sites in the Ogaden Basin, and despite efforts from Addis Ababa to provide assurances to Petronas, Sinopec, and ZEPB, the companies declined to send their personnel back to the region after the incident. It was only in January 2009 that Petronas announced that they had contracted Weather Ford, a Dubai based company, to continue work in the Genale block, blocks 11 and 15. In this second attempt at exploration in the Ogaden, Petronas have commissioned Weather Ford to drill exploration wells and conduct further seismic surveys (Bekele, 2009).

4.4.1.2 Renewed Tensions as Oil and Gas Exploration Continues

On 15 September 2009, the ONLF warned companies again to suspend work in the region. In a statement issued, the ONLF ‘strongly advises multinational corporations that Ogaden is a war zone’ (Mail & Gaurdian, 2009) and they warned oil companies not to venture into the region. The Mail & Guardian (2009) reported that the ONLF warned foreign oil and gas companies that ‘They should not conduct any business activity in [the Ogaden] until there is a political solution to the

conflict' and they said the ONLF 'will not be responsible for any collateral damage that occurs from its engagements with the Ethiopian army' (Guled, 2009). The ONLF reaffirmed their position on this situation in the statement, saying that the oil and gas companies were 'disinheriting the Ogaden people of their natural resources' (Guled, 2009).

On 1 October 2009, the Ethiopian government sought to reassure oil and gas companies with interests in the Ogaden that the rebels were no longer active there. The Minister of Mines and Energy, Alemayehu Tegenu, said in a statement that 'The so-called rebel warning against corporations engaged in exploration in the Ogaden is a falsehood. The ONLF has no capacity to threaten or attack facilities' (Tadesse, 2009). He added that 'Following security measures taken by the [Ethiopian] National Defence Force [(ENDF)], the so-called ONLF does not exist anymore and cannot be considered a security risk' (Tadesse, 2009) reiterating the Ethiopian government's stance that the ONLF has been defeated. Addis Ababa's military forces launched a continued assault against the ONLF, who have been involved in a conflict with the Ethiopian government for more than 20 years, following the Petronas/Sinopec/ZEPB incident.

Tegenu said 'No one has left locations in the Ogaden, work is continuing and there are no security problems in the area' (Tadesse, 2009) where more than a dozen international firms are doing exploration work for oil and gas, bringing much need foreign investment into the region. According to Reuters (Tadesse, 2009) 'The ONLF rebels say they are fighting for self-determination for their home region, an arid land of mainly nomadic herders, but the government considers them a terrorist group supported by arch-foe Eritrea to destabilise the region.' Tegenu concluded his remarks in his 1 October 2009 statement by saying that 'The group, unlike it bluffs, is so weakened at this point and doesn't have capacity to carry out attacks' (Guled, 2009).

The incidents mentioned above and in this sub-section are a pressing concern to the overall stability of the country and are a constant source of possible futures disruptions and conflicts within civil society and within the region under investigation here. The issue of who succeeds Meles is considered 'critical to the survival of the regime and the country's stability' (International Crisis Group, 2009, p. 14). In terms of the prospects for investment in oil and gas, the government in Addis Ababa are more than willing to make the investment climate as attractive as possible for investors, keen to reap the benefits a sustained oil and gas revenue will generate. However, the deep divisions within the region mean that there are non-state actors vehemently opposed to foreign investments that would see the loss of regional natural resources, with no perceived benefit to the local population.

Political: Current Risk Indication –High

4.4.2 Economic

This sub-section will discuss issues pertaining to the following indicators; Economic Performance, Balance of Payments, Credit Worthiness, Currency Convertibility, Energy Vulnerability, Public/Private Sector Mix, and the Current Account Deficit and conclude with a rating that indicates the current level of *Economic* risk.

Ethiopia's economy is heavily dependant on agricultural, with coffee being the key export, a crop that is considerably affected by price fluctuations (BBC News, 2009). Almost 80% of employment, 60% of exports, and over 50% of GDP is derived from agricultural in general, which is often affected by drought and poor cultivation practices (CIA, 2009). According to the CIA World Factbook (2009), 'Under Ethiopia's constitution the state owns all land and provides long-term leases to the tenants; the system continues to hamper growth in the industrial sector as entrepreneurs are unable to use land as collateral for loans.' In terms of the public/private sector mix, the state is heavily involved and owns a number of state enterprises in key industries such as telecoms, which is seen as significant challenge for the fast growing population. As well as coffee and other agricultural produce, the economy has noteworthy amounts of gold, leather products, tantalite, soda ash, and kaolin industries, and is looking to the oil and gas sector to provide a significant sources of revenue in the future. Unemployment and underemployment remains relatively low at 5% (2008) (The Guardian, 2009).

Ethiopia has one of the fastest growing non-oil and gas dependant economies in Africa, with continued double digit growth rates in the past decade until 2008, when real GDP growth slowed to 8.5% (as compared to 11.1% in 2007 and 10.9% in 2006) (CIA, 2009). This robust growth is now being hampered by two macroeconomic challenges, that of high domestic inflation and a difficult balance of payments situation, which have been exacerbated by high food and fuel prices (World Bank, 2009). In July 2008 inflation hit a record high of 64%, but as of January 2009 it had fallen to 38%, and although the government have made efforts to moderate these problems, substantial risk remains. These efforts include; a tightening of fiscal policy, a reduction in government domestic borrowing, mitigating the impact of high food and fuel prices, reducing the domestic borrowing of public enterprises, tightening the money supply, and gradually depreciating the local currency (World Bank, 2009).

In terms of the macroeconomic situation in Ethiopia, the 2007-2008 world economic crisis is now being felt in the country, and the economy is likely to slow in coming years, although the real GDP growth rate will continue to be respectable in terms of the global perspective. The IMF have predicted 2009 year-end figures of 6.5% real GDP growth, with inflation sliding to 20% or lower (World Bank, 2009). According to the World Bank (2009) 'The current account deficit

(excluding official transfers) is expected to remain around 10-11% of GDP during 2008/09.' In 2005, the IMF cancelled Ethiopia's debt as part of the Multilateral Debt Relief Initiative (MLDR), which was follow in 2006 by the World Bank and the African Development Bank, with a 100% cancellation of the country's debt under MDRI (World Bank, 2009). As a result, 'the net present value of external debt to GDP and exports has fallen to 7% and 50%, respectively,' with 'Domestic debt [being] relatively small at 21% of GDP (2007/08) and is expected to decline (World Bank, 2009).

The data and indicators show that economically, Ethiopia has been on a very successful and promising path of sustained growth over the past decade. This has of course slowed considerably because of the 2007-2009 economic crisis, which is only to be expected given its global impact. The added diversification that a fully developed oil and gas industry would bring to the region would be of enormous benefit, along with a stable continued revenue stream that would be welcomed by Addis Ababa. At present the economic system and policies in place do not hinder or hamper FDI into the oil and gas industry, and the government have made a number of efforts to ensure that foreign companies have been able to work on oil and gas projects in the Ogaden. The oil and gas industry would greatly contribute to Ethiopia's economic growth, supplementing and balancing its agricultural income, and may result in an increase in GDP to levels higher than those achieved prior to the economic crisis. As stated, the public/private sector mix remains a challenge to investors, one that will have to be dealt with skilful legalities and contract negotiations.

Economic: Current Risk Indication – Medium

4.4.3 Societal

This sub-section will discuss issues pertaining to the following indicators; Internal Violence, Civil and Labour Unrest, Homogeneity: Ethno-Linguistic/Racial/National, Ethnic Conflict, Community Opposition/Social Licence to Operate, Standard of Living, and Environmental Activism, and conclude with a rating that indicates the current level of *Societal* risk.

According to Human Rights Watch (2008, p. 3), 'Tens of thousands of ethnic Somali civilians living in eastern Ethiopia's Somali Regional State are experiencing serious abuses and a looming humanitarian crisis in the context of a little-known conflict between the Ethiopian government and an Ethiopian Somali rebel movement.' The situation in the Ogaden is regarded as being critical, causing thousands of people to flee after the Ethiopian military stepped up its control and presence in the region mid-2007 in the wake of the Petronas incident. The conflict that ensued between the ONLF and the Ethiopian military after the attacks at the oil exploration

facility in the Degehabur Zone, has created a war-affected area. The Ethiopian military campaign has been charged with 'forced relocations and destruction of villages (...) including arbitrary detentions, torture, and mistreatment in detention' (Human Rights Watch, 2008, p. 3). The five affected Zones of the Somali Regional State are; Fiiq, Korahe, Gode, Wardheer, and Dhagahbur, which comprise the area know as the Ogaden.[103] According to Human Rights Watch (2008, p. 3), 'In these zones the (ENDF) have deliberately and repeatedly attacked civilian populations in an effort to root out the insurgency.'

This situation, combined with 'severe restrictions on movement and commercial trade, minimal access to independent relief assistance, a worsening drought, and rising food prices (...) create[s] a highly vulnerable population at risk of humanitarian disaster' (Human Rights Watch, 2008, p. 3). In 2008, Human Rights Watch (p. 4) 'documented the execution of more than 150 individuals, many of them in demonstration killings, with Ethiopian soldiers singling out relatives of suspected ONLF members, or making apparently arbitrary judgments that individuals complaining to soldiers or resisting their orders are ONLF supporters.' Civilians are targeted by the ENDF based on being ethnic Somali, or members of the Ogaadeeni clan, from which the majority of the ONLF are formed (Human Rights Watch, 2008, p. 4). Like the ENDF, the ONLF have been 'responsible for serious violations of international humanitarian law (...) These include the summary execution of dozens of Chinese and Ethiopian civilians in the context of its April 2007 attack on the oil installation, the ONLF practice of killing suspected government collaborators, and the indiscriminate mining of roads used by government convoys' (Human Rights Watch, 2008, p. 5).

According to Temin (2006, p. 22), 'One of the striking characteristics of conflict in the Somali Region is how quickly conflicts can arise and escalate,' when what can be considered a relatively minor incident can trigger 'a series of events that can rapidly lead to widespread violence' (Temin, 2006, p. 22). One of the contributing factors to this scenario is the prevalence of small arms in the Ogaden, which exponentially increases the risk of violence and conflicts. Hagmann (2005) notes that 'all pastoralists in the [Hashin] district possess firearms, a result of the Somali civil war and the influx of small arms,' and this is true of most of the Somali Regional State. In a climate of clan based conflict, and a lack of state provided security, 'it falls to the individual, family and clan to provide their own protection' (Temin, 2006, p. 23). A further factor exacerbating this scenario is the large, restless, frustrated, unemployed or underemployed, and easily mobilized youth; as research suggests, there is 'a strong correlation between large youth cohorts and political violence' (USAID, 2005).

[103] See Map 2: Somali Regional State, sub-section 2.4.2 The ONLF: The Conflict over the Independence for the Ogaden

There is little doubt that the societal situation in the Ogaden is intertwined with regional dynamics concerning Ethiopia, Eritrea, and Somalia. The Ethiopian government is faced with complex challenges in the face of the ONLF who are seeking autonomy and independence in the region. However, the position of the ONLF is not the position of the entire Ethiopian Somali community in the region, it represents only a segment of a divided population. Human Rights Watch (2008, p. 5) argue that 'There are legitimate fears that the escalating conflict across the border in Somalia could spill into Ethiopia.' Further, 'The authorities face difficult questions on how to best establish the rule of law in a remote, povertystricken region largely inhabited by pastoralists who have little knowledge of or confidence in state institutions that have long neglected them' (Human Rights Watch, 2008, p. 5). 'The Ethiopian government's politicized manipulation of humanitarian operations, particularly food distribution, plus the continued restrictions on commercial traffic and trade are creating a situation that—in combination with the drought produced by failed rains—could quickly slip into catastrophe' (Human Rights Watch, 2008, p. 6).

The societal factor is the largest hurdle to the stability and security of investments made in the oil and gas industry in the Ogaden. Ethnic divisions have given rise to internal violence in the state and within the region, with civil unrest in the Ogaden seen as a constant potential problem. The ONLF have taken a stand, in the name of the community, in opposition to the investments and developments of the foreign oil and gas industry that is seeking to establish itself in the region. Whether the stand taken by the ONLF actually represents the majority of ethnic Somalis living in the Ogaden is debateable. Currently, these societal related risks in the Ogaden are the most significant and real threat to investors, with a situation having the potential to be extremely dangerous for both the personnel and assets of investors.

Societal: Current Risk Indication – Extreme

4.5 Applying the Model and Scoring the Indicators

As mentioned earlier in this chapter and in the previous one,[104] without knowledge of the investor, only a *phase one political risk analysis* can be undertaken. The model presented in Table 5 is an expanded version of the *Host Country Political Risk* (excluding *Petroleum*) component of the *phase one* and *phase two* political risk model developed in chapter three. The scoring process is as explained in the previous chapter[105] and will produce a final score out of 100, which will then

[104] See section 4.1 Introduction and sub-section 3.5.1 Defining the Model

[105] See section 3.5 A Political Risk Model for the Oil and Gas Industry, particularly sub-section 3.5.5 Phase One and Two Political Risk Model: Practical Aspects of Using the Model

be measured against the *scale for investment and political risk indication*[106] to determine political risk and investment indication associated with the Ogaden. Additionally, the score can be interpreted by using the example of the *phase one guidelines*,[107] adding further detail in terms of three different categories: *security* (including; safety, terrorism, and travel), *investment*, and *political and economic situations*.[108]

Like the *phase one* and *phase two* political risk model, each of the factors in the *phase one* political risk model carries a percentage weight (of a total 100% combined across the factors). Here, percentage weights are assigned to certain factors depending on the impact that factor has relative to the analysis and to the other factors. Further, the three core risk factors have had their respective indicators separated into macro and micro levels, with each given a percentage weight. For example, the macro societal weight is 19% of the model, while the micro societal weight is 29% of the model. This is because the indicators concerned with micro societal level issues have more impact to this analysis than the indicators assigned to the macro societal level issues. Further, at 29%, the micro societal weight is the highest in the model, and combined with the macro societal weight is 48% in total indicating its impact relative to the other core risk factors, be they separated into macro or micro levels or not.

In the final analysis, the Ogaden region of the Somali Regional State in eastern Ethiopia, which includes the potentially hydrocarbon rich Ogaden Basin, achieved a score of 67.4 on the *phase one* political risk model specific to the oil and gas industry. In terms of the *scale for investment and political risk indication*, the score puts the region in the high risk indication bracket (61-80), and in terms of investment, this score situations the region in the moderate to high risk bracket (61-70). Thus, in terms of the score the Ogaden can be considered a high political risk region and a moderate to high risk region for investments in oil and gas industry in the region.

Overall Political Risk in the Ogaden – High

Overall Oil and Gas Investment Risk in the Ogaden – Moderate to High Risk

[106] See sub-section 3.5.6 Scale for Investment and Political Risk Indication, Table 2

[107] See sub-section 3.5.7 Phase One Guidelines: Security, Investment, Political and Economic Situations

[108] See Table 10: Guideline for Security Situation, Appendix D, Table 11: Guideline for Investment Situation, Appendix D, and Table 12: Guideline for Political and Economic Situation, Appendix D

Phase One Political Risk Model including Macro and Micro Indicators				
Factors (Weight)		Indicators	Rating	Score
Macro Level	Political 24%	Regime/Political Stability	3	14.4
		War and Security Issues	4	
		Repatriation Restrictions	2	
		Corruption/Poor Governance	3	
	Economic 9%	Economic Performance	2	4.5
		Balance of Payments	2	
		Credit Worthiness	3	
		Currency Convertibility	3	
	Societal 19%	Internal Violence	4	15.2
		Civil and Labour Unrest	4	
Micro Level	Political 8%	Unclear Legislation/Security of Tenure	2	4.0
		Investment Constraints	3	
	Economic 11%	Energy Vulnerability	4	7.3
		Public/Private Sector Mix	3	
		Current Account Deficit	3	
	Societal 29%	Homogeneity: Ethno-Linguistic/Racial/National	4	22.0
		Ethnic Conflict	5	
		Community Opposition/Social Licence to Operate	4	
		Standard of Living	4	
		Environmental Activism	2	
Total				67.4

Table 5: Phase One Political Risk Analysis of the Ogaden

4.5.1 Applying the Phase One Guidelines

Using the *phase one guidelines* as an example of *security, investment, political and economic situations*,[109] the following can be said regarding oil and gas companies operating in or intending to operate in the Ogaden with the support of Addis Ababa, but not the local ethnic majority spearheaded by the ONLF. In terms of security (including; safety, terrorism, and travel) there is a probability that foreign oil and gas companies operating in the region will face security problems, such as violent attacks, terrorism (including kidnapping) and other violent crimes. These security problems will require special measures to be put in place to counter them, such as; increased

[109] See sub-section 3.5.7 Phase One Guidelines: Security, Investment, Political and Economic Situations, Table 10: Guideline for Security Situation, Appendix D, Table 11: Guideline for Investment Situation, Appendix D, and Table 12: Guideline for Political and Economic Situation, Appendix D

security personnel; high-level physical protection of the assets and personnel; and an advanced evacuation procedure which is on high alert standby. The assets and personnel of oil and gas companies operating in the Ogaden will be at a constant risk from violence, particularly from non-state actors such as the ONLF. Further, there is a high risk of collateral damage from terrorism or other violence associated with the ongoing clashes between the ONLF and the ENDF. While law and order is generally satisfactory in the Ogaden, state protection is very limited or inadequate. Travel in the Ogaden may be difficult and require advanced planning, with the possibility of being frequently disrupted by non-state actors or the engagement between these actors and the state.

The terrorist activities of the ONLF such as the Petronas incident, coupled with the political unrest in the region pose a serious risk to the operations of oil and gas companies in the Ogaden. Foreign personnel are likely to be targeted by the ONLF and are thus at an increased risk of incidental exposure to violence. Investment in the Ogaden is possible but conditions are difficult, with little security for investments. Foreign oil and gas companies may be exposed to a number of risks, and the economic and political conditions may become rapidly unstable due to the ongoing conflict with the ONLF, as well as the border tensions with Somalia and Eritrea. As a result of the unlawful actions of the ENDF in the Ogaden, which are said to breach international human rights conventions, international sanctions are possible if such abuses continue. In terms of the political and economic situation, the investor can expect a political system that is somewhat disruptive, with a degree of uncertainty and/or instability surrounding it. This is particularly true in the Ogaden, which is far less stable politically than the country as a whole. There is level of countrywide civil opposition in Ethiopia, with more than frequent violence in the Somali Regional State due to political issues. Human rights abuses are sporadic but have been cited to occur in the Ogaden due to the conflict between the ONLF and the ENDF. The economic system in Ethiopian is relatively stable; however, the uncontrolled inflation of 2008 is worrying, even though effective measures have been put in place to control this situation.

4.6 Recommendations for Political Risk Management (Risk Mitigation)

The recommendations for political risk management (risk mitigation) for investors in the oil and gas industry are covered in chapter three.[110] However, beyond these approaches there are other avenues the investor may choose to follow, such as a commitment to engage with local stakeholders. Community relations strategies should be creative in their outlook and involve a high degree of local community participation in projects. These initiatives should extend beyond simply offering financial incentives to a more genuine form of community interaction with

[110] See sub-section 3.6.2 Political Risk as a Management Tool / Risk Mitigation (*Ex Post*)

extensive local consultation. Strategies, policies, and procedures should be developed that ensure that employees engage productively with NGOs and the media at local levels in order create a suitable environment for all. If this practice is followed consistently and with a genuine engagement with the community, the investor and investment elevates itself above others that do not engage with local stakeholders. In doing so, the investor becomes well versed in all the aspects of political risk involved in the investment, be they traditional, existing, or new. Having an understanding of the environment and the political risks faced enables the investor to make sophisticated, informed, and rational decisions about the political risk associated with the investment. This process can enable the implementation of value-creating risk management programmes, allowing investments to flourish in the region, and consequently, creating substantial and enduring value for the investor (Control Risks, 2009a).

4.7 Conclusion

The focus of this chapter has been on issues surrounding investing in the oil and gas industry in troubled territories, with a *phase one political risk analysis* presented using the Ogaden and its potential for oil and gas investment as the case study. The analysis provided insight on the geographical region under investigation, as well as the status of the oil and gas industry in that region, followed by a *phase one political risk analysis* of the region using the relevant factors and indicators selected. The political risk model specific to the oil and gas industry developed in chapter three was applied to the case study in order to arrive at an overall rating for the Ogaden, which resulted in a high political risk rating and a moderate to high risk rating for investment, both derived from the *scale for investment and political risk indication*. The chapter also provided information on political risk management (risk mitigation) in the form of recommendations to the investor.

Chapter five will conclude the study with an overview of the research undertaken in chapters two, three, and four in context of the research question and the aims and objectives of the study. This chapter will also focus on the relevance of political risk analysis, and the need for further research in certain areas of the field. The research study will conclude with a final analysis of the extraction industry, specifically oil and gas in eastern Ethiopia's Ogaden region, in terms of the political risk associated with foreign investment in this sector.

CHAPTER FIVE: EVALUATION AND CONCLUSION

5.1 Introduction

This research study began by focusing on the oil and gas industry, and the need therein to maximise profit and minimise cost, with all the difficulties of achieving this as energy demands increased while resources decrease. In order to keep up with international and domestic demand, and maintain a level of profit that assures sustainability and continued existence for the companies in this industry, there has been and continues to be a search for new sources of supply of petroleum reserves. For the oil and gas industry, this has led to investing in new territories, some of which pose a potential political risk for new investments. Globalisation was shown to be the key driving force behind the increasing number of investments in troubled territories, such as the Ogaden. Along with the integration of the global market place in the late 20th century, additional continuous and fluctuating factors were acknowledged for their role in the oil and gas industry has increased investment in regions with a potential for high political risk. Fluctuating factors included events such as the 2007-2009 economic crisis, and the decline of nationalisation in the 1970's, while continuous factors include supply stability, operational capacity, resource depletion, and economic growth.

The central research question of this study concerned the level of political risk that the Ogaden region of eastern Ethiopia posed for companies operating in, or intending to operating in the oil and gas industry in that region. The aim of this research was to answer that question, by conducting a political risk analysis of the Ogaden using an industry specific political risk model, which would be developed in the course of the study. As well as answering this main research question, two further sub-questions were posed in the research problem. The first sub-question concerned what factors and indicators would be included in a political risk analysis specifically envisaged for the oil and gas industry, which would be used to assess the political risk in the Ogaden. The aim here was to select the salient factors and indicators that would best serve an assessment of the oil and gas industry, and to construct a model that would do the same. The second sub-question addressed the practical application of political risk and the analysis thereof as both a decision-making and risk management tool for investors. Here the aim was to look at the role political risk plays in both *ex ante* (risk assessment) and *ex post* (risk mitigation) situations; and how political risk and the analysis thereof could be of benefit to the investor and the investment.

Concurrently, in the process of developing a political risk model specific to the oil and gas industry, a measure for rating the outcome, or achieved score of the countries or regions the model was applied to, was developed. The measure, termed the *scale for investment and political*

risk indication, provided a quick and concise indication of the risk to be expected by the investor for the investment in terms of a ranking from nominal risk to extreme risk. The measure also included a scale for investment to provide a recommendation to the investor as to whether or not it is advisable to invest in the country or region under examination, in terms of a ranking from highly advisable to highly unadvisable. This was followed by more detailed *phase one guidelines* of what the investor could expect in terms the *security, investment, political and economic situations* of the country or region assessed. Here the aim was to provide example guidelines as means to interpret the score from the *phase one* component of the political risk model. These guidelines provide the analyst and the investor with a general overview of what the score achieved by the industry specific model may mean in terms of the three different categories (*security, investment, political and economic situations)*.

This chapter brings the study to its conclusion beginning with a brief summation of the research up to this point. The remainder of this chapter centres on an evaluation of the research study, from the broad to the specific. These sections aim to answer a number of questions regarding the overall successes, or failures, of the study in terms of the research problem, and the objectives and relevance of the research. Here issues pertaining to the political risk model specific to the oil and gas industry will be discussed and evaluated, as well as its suitability for a political risk analysis, as evidenced by the case study of the Ogaden. The final section before the conclusion of this study will look at recommendations for further research. The chapter will end with a conclusion to the research study, and an evaluation of the field of political risk, specifically relating to the oil and gas industry where relevant.

5.2 Course of the Research Study

The focus of chapter one was on introducing the research study with a general introduction followed by a brief literature survey. The research problem discussed the genesis of the study and its formulation, while the research objective was recognised as an attempt clarify the political risk associated with the extraction of resources from the Ogaden. The main research question and two sub-questions were identified, and the research design and data gathering methods were outlined. Finally, the limitations and delimitations of the research were presented.

The focus of chapter two was on the conceptualisation of key political risk related terms central to this research study. The chapter also contextualised the research study with a look at the history of the conflict in the Ogaden from the Ethiopian government, Somali, and ONLF perspectives, and the role the discovery of oil and gas in the Ogaden has played. The purpose of this chapter, in examining the theoretical perspective and contextualisation, was to create a

foundation and framework on which the industry specific political risk model could be built in chapter three and applied to the case study in chapter four.

Chapter three focused on industry specific political risk analysis and the practical application thereof. The objective was to develop a framework based on the underlying theory of political risk set out in chapter two by disseminating additional literature concerning the practical relevance and use of political risk and the analysis thereof. This was further enhanced through an analysis of political risk and it relationship firstly to the global environment, secondly to the oil and gas industry, and finally in relation to industry specific political risk analysis. Variables relevant to the oil and gas industry were discussed, as well as the methodology behind building a political risk model, before the political risk model specific to the oil and gas industry was presented. This chapter concluded with a look at political risk analysis as a decision-making and management tool.

The focus of chapter four was a political risk analysis of oil and gas investments in the Ogaden, using the *phase one* component of the political risk model specific to the oil and gas industry developed in chapter three. The analysis provided insight on the geographical region under investigation, as well as the status of the oil and gas industry in the Ogaden followed by a *phase one political risk analysis* of the region using the relevant factors and indicators. This resulted in a high political risk rating and a moderate to high risk rating for investment, both based on the *scale for investment and political risk indication*. The chapter also provided *phase one guidelines* on the *security, investment, political and economic situations* in the Ogaden, as well as issues concerning the management (risk mitigation) of political risk in the form of recommendations to investors.

Chapter five concludes the study with an overview of the research in the context of the research question and the aims and objectives of the study. This chapter also provides a reflection on the course of the research study, its successes, and failures, looking at what would be done differently if the research study was repeated, as well as issues pertaining to the effectiveness of the model. The chapter will conclude with recommendations for further research in certain areas in the field political risk and its relationship to the extraction industry.

5.3 Evaluation of the Research Study

The African continent, although presenting a challenging investment climate, has shown to have significant potential that could yield considerable returns for the investor, as evidenced by the examples of Angola and Nigeria, both extremely prosperous, despite the difficulties associated with those countries. The key to such profitability is timing, as Alon et al. (2006, pp. 623-4) alluded to, ‘Multinational corporations around the world realize the importance of capturing an early

market share, even in locales that may seem risky prospects.' It is at this point that political risk and the analysis thereof can merge with the interests of the investor and play a decisive role when it comes to investments. Political risk benefits and gives insight into forecasting issues surrounding investments, and this dimension of the investment process is invaluable to the investor. As Brink (2004, p. 1) states 'The term investment implies an expected return,' however a return is not always guaranteed, and the investor 'runs the risk of not receiving expected returns, making fewer gains on the investment, or losing the investment entirely' (Brink, 2004, p. 1).

The purpose of this research study was to expand on high risk investments by the oil and gas industry in troubled territories by examining the political risk associated with the fledgling oil and gas industry in the Ogaden region of eastern Ethiopia. The Ogaden proved to be excellent choice for a case study as it met all the requirements needed to undertake this research study. The region was embroiled in a long term, but little known conflict, which meant there was room for further research, and the discovery of oil and gas in the past decade positioned the Ogaden on the cusp of developing a fully-fledged oil and gas industry, with all the problems associated with such a vast development. The nexus of these two aspects made the region the perfect choice to explore the political risk associated with the investments in the oil and gas industry in such regions. Like high political risk countries such as Angola and Nigeria, Ethiopia's Ogaden was thought to be an almost certain high political risk region, which the *phase one political risk analysis* in chapter four showed to be the case.

5.4 Answering the Research Question

The main research question of this study was what is the level of political risk that the Ogaden region of eastern Ethiopia poses for companies operating in the oil and gas industry? The question was answered using a *phase one* political risk model developed specifically for the oil and gas industry. This model was developed based on the foundations established in chapter two, which focused on the underlying theory of political risk and the key political risk concepts central to this research study, and the framework presented in chapter three, which focused on industry specific political risk analysis and the practical application thereof. The *phase one political risk analysis* of the Ogaden returned a score that placed the region in the high risk category, and in terms of investment, the score indicated a moderate to high risk for investments in the oil and gas industry. As discussed in this research study, a high political risk does not mean that investors should stay away from a country or region; it could represent possible 'lucrative future opportunities to more aggressive competitors' (Alon et al., 2006, p. 624). A high degree of risk, if sufficiently managed, can result in increased opportunities for higher returns for the investor.

The first sub-question that was identified supplemented and supported this main research question, it concerned the factors and indicators that would be included in a political risk model specifically envisaged for the oil and gas industry. The literature and data sources covered in this research study introduced a number of factors and indicators that could be used in a political risk model specifically envisaged for the oil and gas industry. These were *trimmed* down to what was considered the most salient and relevant variables, those that allowed for the creation of the *phase one* and *phase two* political risk model for the oil and gas industry. The factors and indicators that were tested in the *phase one* component of the model, that was used to evaluate the Ogaden, proved both useful and successful for the desired outcomes, which was to deliver an accurate, practical and effective assessment of the region, and the political risks faced by investors in the oil and gas industry in that region. The true test of the model and all the selected factors and indicators (i.e. including the *phase two* component) is to conduct a full *phase one* and *phase two political risk analysis*, with knowledge of the investment, investor, and home country. Only then would a complete assessment of the model's performance be able to be undertaken. This would be further enhanced by increasing the number of case studies applied to the model, thus allowing comparisons to be made, giving a better reflection of the scores achieved.

The second sub-questions identified that supplemented and supported the main research question, concerned the practical application of political risk as a decision-making (risk assessment) and management (risk mitigation) tool for investors. This research study revealed that although the process of political risk analysis is often *ex ante*, for the oil and gas industry the decision to invest has usually already been made given the geological benefits and potential for profit of the investment. The political risk analysis that is undertaken prior to the investment going ahead is therefore more a precursor of the potential risks that will be part of the investment. The way in which an *ex ante* political risk assessment will be of value to the investor is in how it informs the way in which the investor moves forward with the investment. It was discovered that beyond the traditional approaches to political risk management (and mitigation), such as political risk insurance, there are other avenues that the investor may choose to follow, such as a commitment to engage with local stakeholders. These initiatives should extend beyond mere financial incentives to a more genuine form of community interaction, with extensive local consultation. Strategies, policies, and procedures should be developed that ensure that companies engage productively with NGOs and the media at local levels in order create a suitable environment for all. Political risk is more than simply providing an assessment with a risk rating tagged to the end of the report. It should be a fully integrated part of the investment, essential to the continued success and profitability of the investment for the investor.

5.5 Recommendations for Further Research

There is certainly a need to expand on other areas of political risk, specifically in terms of its relationship with the broader extraction industry, of which only one sector has been examined here, the oil and gas industry. Within the oil and gas industry, there is scope for conducting research on the validity of political risk analysis at the corporate, regional, country, and operational location level, to evaluate the strength of this approach. Within the field of industry specific political risk analysis in the oil and gas industry, there are a number of recommendations outlined below which would be of benefit. Primary data from both the political risk industry itself and the extraction industry would greatly enhance the knowledge regarding real world development and application of political risk models. This would take the form of interviews with key individuals from both industries aimed at understanding the relationship these industries have with one another and the benefits that political risk analysis brings to the oil and gas industry, and the greater extraction industry. The goal here is to be exposed to political risk analysis in a more direct way, and although still faced with the intellectual property right barrier, be able to cultivate a more accurate picture of the inner workings of this industry and its engagement with the oil and gas industry.

Further, a number of additional case studies and examples could be explored in the same vein as Angola LNG and BP, both of which provided *on the ground* insights into the processes involved in political risk, either in the form of the decision-making or the management aspects. Locating a new oil and gas industry development or operation, such as a pipeline, oil refinery, harbour development, or a mining project, which has had an impact on a local population, and doing primary research would be of great benefit. Here the researcher could undertake field research, conducting interviews with the people directly affected, including: local villagers and workers; local chiefs and elders; local, regional and national politicians; NGOs; those active in the community and community healthcare; the media; and local police amongst others. Here the researcher would be able to build a more complete picture of the processes involved, the consultations that took place, the concessions, and the compromises made, all on the site where the development/operation would have the most impact.

This field research would form half the picture of the process of political risk analysis, specifically focusing on the management side of the project, while interviews conducted in capital cities of the world with political risk analysts and extraction industry executives would form the basis of the other half of the research. This would bring together two vastly different worlds; that of the rural villages in often-inaccessible parts of the world such as Africa, South East Asia and South America, contrasted with the executive boardrooms in capital cities such as London, New

York and Shanghai. Here two extreme opposites would be brought together in a level of research that would provide a much greater understanding of the inner workings of this under-rated and essential field. Political risk seamlessly bridges the boundaries between the academic and the practical, bringing political theories out of the realm of observation and examination, and into the real world. It is a field that has the ability to focus years of training in political theory, in a precise way, in a growing industry of political risk practitioners and analysts.

5.6 Conclusion

This section ends this research study, which has been an exploration of the field of political risk and its relationship with the oil and gas industry, using the case study of the Oagden region of eastern Ethiopia. It is practically impossible to gather all the relevant information when undertaking a political risk analysis, to know all the *unknowns*. It would take an immense amount of time to attempt such an analysis and the costs would be exorbitant. In creating a *phase one* and *phase two* political risk model that is specific to the oil and gas industry, a methodological approach was adopted to streamline this process. One of the challenges of this research study was to engage in this streamlining process; by examining and selecting the most salient variables that could then be incorporated into the political risk model specific to the oil and gas industry, which would yield both realistic and practical results.

Political risk and the analysis thereof is currently experiencing a revival of sorts, certainly a reorganising of the discipline as it finds its place in the 21st century. This is one of the reasons that this research study is seen as contributing to the field of political risk in the form of industry specific political risk analysis. It is here that political risk has the potential to play a pivotal role for both the communities affected by the oil and gas industry's developments and operations, as well as the for oil and gas industry itself. Political risk and the analysis thereof can be used as a component of the decision-making process (risk assessment) for potential investors as well as component of the management process (risk mitigation) of the political risk associated with investments. The field of political risk can be seen as bridge between politics and business. Understanding the character of that bridge, its construction, and its strengths and weaknesses, assists in understanding the political risk involved with an investment. Thus, industry specific political risk analysis brings added value to the study of political risk.

In a recent documentary on Robert S. McNamara, whose credentials include; Harvard graduate and later assistant professor there, former President of the Ford Motor Corporation, seven years as Secretary of Defence under Presidents John F. Kennedy and Linden B. Johnston, and 13 years as the President of the World Bank, 11 lessons were identified from his experience

of life in business and politics. Several of these are relevant to the study of political risk, a field that is at the nexus of politics and business. Among these are the following: rationality will not save us; maximise efficiency; belief and seeing are often both wrong; be prepared to re-examine your reasoning; never say never; you can't change human nature; and finally, the most relevant to this research study, get the data (Morris, 2008). Political risk analysts needs to mindful of all of these lessons, and to consider them when conducting an analysis, especially in troubled territories.

BIBLIOGRAPHY

Africa Oil Corp. (2009, June 23). *World-Class East Africa Oil Exploration Play: Somalia, Ethiopia and Kenya.* Retrieved August 15, 2009, from Africa Oil Corp.: http://africaoilcorp.com

Alon, I., & Martin, M. A. (1988). A Normative Model of Macro Political Risk Assessment. *Multinational Business Review , 2* (6), 10-19.

Alon, I., Gurumoorthy, R., Mitchell, M. C., & Steen, T. (2006). Managing Micropolitical Risk: A Cross-Sector Examination. *Thunderbird International Business Review , 48 (5)* (September - October), 623-642.

American Chronicle. (2009). *About Us*. Retrieved 06 23, 2009, from American Chronicle: http://www.americanchronicle.com/aboutus

Babbie, E., & Mouton, J. (2005). *The Practice of Social Science Research. South Afrcian Edition.* Cape Town: Oxford.

BBC News. (2009, April 15). *Country Profile: Ethiopia.* Retrieved July 10, 2009, from BBC News: http://news.bbc.co.uk/go/pr/fr/-/2/hi/africa/country_profiles/1072164.stm

Bekele, K. (2009, January 5). *Ethiopian News: Petrons to drill exploration wells in Ogaden*. Retrieved July 10, 2009, from Ethiopian Review: http://www.ethiopianreview.com/news/4474

Bekele, K. (2009, January 9). *Petronas to Drill Exploration Wells in Ogaden.* Retrieved July 6, 2009, from Ethiopian Review: http://www.ethiopianreview.com/news/4474

Berlin, A. (2003, March). *Managing Political Risk in the Oil and Gas Industries*. Retrieved 06 23, 2009, from http://www.stephankinsella.com/texts/berlin political-risk.pdf

Boulos, A. J. (2003). *Assessing Political Risk.* NAPE International Forum. Houstin: International Petroleum Association of America.

BP. (2009). *About Us*. Retrieved 07 05, 2009, from BP: http://www.bp.com/aboutus

Bremmer, I. (2009, January 5). *Ian Bremmer, the President of Eurasia Group, announces top political risks for 2009.* Retrieved July 05, 2009, from Political Risk Insurance Centre: http://www.pri-center.com/feature/index.cfm?fid=36

Bremmer, I., & Keat, P. (2009). *The Fat Tail: The Power of Political Knowledge for Strategic Investment.* New York: Oxford University Press.

Brink, C. H. (2004). *Measuring Political Risk: Risk to Foreign Investment.* Aldershot: Ashgate Publishing.

Chevron. (2009, August 22). *About Us*. Retrieved August 22, 2009, from Cheveron: http://www.chevron.com/about/

CIA. (2009, June 26). *Africa: Ethiopia.* Retrieved August 15, 2009, from CIA - The World Factbook: http://www.cia.gov/publications/the-world-factbook/geos/countrytemplate_Ethiopia.htm

Control Risk. (2009c). *CRG Four-Star Rating for Risk.*

Control Risks. (2009b). *About Us*. Retrieved July 05, 2009, from Control Risks: http://www.control-risks.com/aboutus/

Control Risks. (2009a). *Controlling political risk in mining operations.* Retrieved September 07, 2009, from Control Risks: http://www.controlrisks.com

Cosset, J. (1991). The Determinants of Country Risk Ratings. *JOurnal of Internation Business Studies , 1* (22), 135-142.

Doing Business. (2009a). *Angola*. Retrieved June 23, 2009, from Doing Business: http://www.doingbusiness.org/ExploreEconomics/?economyid=7

Doing Business. (2009b). *Ethiopia*. Retrieved June 23, 2009, from Doing Business: http://www.doingbusiness.org/ExploreEconomies/?economyid=66

Doing Business. (2009c). *Home Page*. Retrieved June 23, 2009, from Doing Business: http://www.doingbusiness.org

Doing Business. (2009d). *Nigeria*. Retrieved June 23, 2009, from Doing Business: http://www.doingbusiness.org/ExploreEconomies/?economyid=143

EIA. (2009a). *About Us*. Retrieved June 23, 2009, from Energy Information Administration: http://www.eia.doe.gov/aboutus

EIA. (2009b). *Angola - Background - March 2008*. Retrieved June 23, 2009, from Energy Information Agency: http://www.eia.doe.gov/cabs/Angola/Background.html

EIA. (2009c). *Angola - Natural Gas - Month 2009*. Retrieved June 23, 2009, from Energy Information Administration: http://eia.doe.gov/cabs/Angola/NaturalGas.html

EIA. (2009d). *Angola - Oil - March 2008*. Retrieved June 23, 2009, from Energy Information Administration: http://www.eiadoe.gov/cabs/angola/oil.html

EIA. (2009e). *Nigeria - Background - March 2008*. Retrieved June 23, 2009, from Energy Information Angency: http://www.eia.doe.gov/emeu/cabs/Nigeria/Background.html

EIA. (2009f). *NIgeria - Oil - May 2009*. Retrieved June 23, 2009, from Energy Information Agency: http://www.eia.doe.gov/emeu/NIgeria/Oil.html

Encyclopedia Britannica. (2009). *History of East africa*. Retrieved July 27, 2009, from Encyclopedia Britannica Online: http://www.britannica.com/EBchecked/topic/176961/histroy-of-eastern-Africa

EPRDF. (2009). *About Us*. Retrieved August 05, 2009, from Ethiopian People's Revolutionary Democratic Front: http://www.eprdf.org/aboutus

Ethiopian Ministry of Mines and Energy. (2009, July 01). *Petroleum Exploration Potential of Ethiopia.* Retrieved August 15, 2009, from Ethiopian Ministry of Mines and Energy: http://www.mom.gov.et/petroleum.html

Eurasia Group. (2009). *About Us*. Retrieved July 05, 2009, from Eurasia Group: http://www.eurasiagroup.com/aboutus

Exclusive Analysis. (2009a). *About Us*. Retrieved July 7, 2009, from Exclusive Analysis: http://wwwexclusive-analysis.com/aboutus.html

Exclusive Analysis. (2009b). *Engergy - Sector Expertise*. Retrieved July 6, 2009, from Exclusive Analysis: http://www.exclusive-analysis.com/services/energy_sector.html

ExxonMobil. (2009, August 22). *About Us*. Retrieved August 22, 2009, from ExxonMobil: http://www.exxonmobil.com/Corporate/about.aspx

Fitzpatrick, M. (1983). The Definition and Assessment of Political Risk in INternational Busines: A Review of the Literature. *Academy of Management Review , 2* (8), 249-254.

Freeman, J., & Job, B. (1979). Scientific Forecasts in International Relations: Problems of Definition amd Epistemology. *International Studies Quarterly , 1* (23), 113-143.

Frynas, J. (1998). Political Instability and Business: Focus on Shell in Nigeria. *Third World Quarterly , 3* (19), 457-478.

Fund for Peace. (2009a). *About Us*. Retrieved August 10, 2009, from Fund for Peace: http://www.fundforpeace.org/web/index.php?option=com_content&task=view&id=58&Itemid=87

Fund for Peace. (2009b). *Ethiopia - 2008 Report*. Retrieved 2009, from Fund for Peace: http://www.fundforpeace.org/ethiopia08

Garad, A. (2009, March 24). *State of the Ogaden: The Impossible Mission*. Retrieved August 10, 2009, from American Chronicle: http://www.americanchronicle.com/articles/printFriendly/95728

Gebre-Mariam, A. (2005). The Critical Issue of Land Ownership: Violent Conflict Between Abdalla Tolomogge and Awlihan in Godey Zone, Somali Region of Ethiopia. *WP 1 "Governance and Conflict Transformation" Working Paper No. 2.* Bern: NCCR North-South.

Guled, M. (2009, September 29). *International News: Ethiopia vows to continue oil venture amide rebel threat*. Retrieved October 10, 2009, from Somali Land Press: http://somalilandpress.com/8871/ethiopia-vows-to-continue-oil-venture-amide-rebel-threat/

Hagmann, T. (2005). Beyond Clannishness and Colonialism: Understanding Political Disorder in Ethiopia's Somali Region 1991-2004. *Journal of Modern African Studies , 43* (4).

Hallmark, T., & Whited, K. (2001). The IHS Energy Group's Political Risk Rating and Ranking Index. In L. D. Howell, *The Handbook of Country and Politcal Risk Analysis* (pp. 22-27). East Syracuse, NY: PRS Group.

Hawkins, T. (1996). *Country Risk Profiles with Specific Reference to Southern Africa.* ISSUP Bulletin.

Hough, M., Du Plesis, A., & Kruys, G. P. (2008). *Threat and Risk analysis in the Context of Strategic Froecasts* (Vol. 45). Pretoria: University of Pretoria - Institute for Strategic Studies.

Howell, L. D. (1998). *The Handbook of Country and Political Risk Analysis.* New York: PRS Group.

Human Rights Watch. (2009). *About Us*. Retrieved August 10, 2009, from Human Rights Watch: http://www.hrw.org/en/about

Human Rights Watch. (2008, June). *Collective Punishment: War Crimes and Crimes against Humanity in the Ogaden areas of Ethiopia's Somali Region.* Retrieved June 23, 2009, from Human Rights Watch: http://www.hrw.org

IEA. (2009). *About Us*. Retrieved 06 23, 2009, from International Energy Agency: http://www.iea.org/about/index.asp

IHS. (2009). *About IHS.* Retrieved 07 05, 2009, from IHS: http://www.ihs.com/About-IHS/

International Crisis Group. (2009, September 4). *Ethiopia: Ethnic Federalsim and its Discontents: Africa Report N°153.* Retrieved October 01, 2009, from International Crisis Group: http://www.crisisgroup.org/home/index.cfm?id=6300

Knott, D. (1997, June 9). BP Molds Security Strategy to Fit the Country. *Oil & Gas Journal* , 31-33.

Kobrin, S. (1979). Political Risk: A Review and Reconsideration. *Journal of International Business Studies , 10* (1), 67-80.

Kobrin, S. (1978). When Does Political Instability Result in Increased Investment Risk? *Columbia Journal of World Business* (Fall), 113-122.

Lax, H. L. (1983). *Political Risk in the Oil and Gas Industry.* Boston: Internationa Human Resource Development Corporation.

Leonard, A. (2007, April 24). *Technology: Blood for oil in the Horn of Africa*. Retrieved July 10, 2009, from Salon.com: http://www.salon.com/tech/htww/2007/04/24/ogaden/print.html

Lhuillery, J. (2009, 07 26). *Nigeria's Oil Output Falls*. Retrieved 07 28, 2009, from News24.com: http://www.news24.com

Mail & Gaurdian. (2009, September 17). *Ethiopia rebels warn oil firms in Ogaden*. Retrieved October 10, 2009, from Mail & Gaurdian: http://www.mg.co.za/article/2009-09-17-ethiopia-rebels-warn-oil-firms-in-ogaden

Markwick, S. (2001). Customising Risk Analysis as a Tool for Strategic Management. In L. D. Howell, *The Handbook of Country and Political Risk Analysis* (pp. 37-46). East Syracuse, NY: PRS Group.

Micalleff. (1981). PowerPoint Web CT. *Stellenbosch University* .

Morgan, T. H. (1998). Lessons in the Management of International Political Risk from the Natural Resources and Private Infrastructure Sectors. In T. H. Morgan, *Managing International Political Risk* (pp. 70-79). Malden, MA: Blackwell.

Morris, E. (Director). (2008). *The Fog of War: Eleven lessons from the life of Robert S. McNamara* [Motion Picture].

Multilateral Investment Guarantee Agency. (2008, December). *The Global State of Political Risk in the Wake of the Financial Crisis: A Question and Answer with Control Risks.* Retrieved June 23, 2009, from Political Risk Insurance Centre: http://www.pri-center.com/documents/Global State08.pdf

OgadenNet. (2009, June 08). *ONLF Press Release*. Retrieved July 08, 2009, from OgadenNet: http://www.ogadennet.com/blog/?p=3

OHCR. (2009). *About Us*. Retrieved July 10, 2009, from OHCR: http://www.ohcr.org/about us

OHRC. (2007, April 29). *Ogaden: Overseas Oil Companies Exacerbate Human Rights Situation*. Retrieved July 10, 2009, from Mathaba.Net: http://mathaba.net/news

ONLF. (2009). *News*. Retrieved 06 23, 2009, from Ogaden National Liberation Front: http://www.onlf.org/news.php

OPEC. (2009a). *About Us*. Retrieved June 23, 2009, from Organisation of Petroleum Exporting Countries: http://www.opec.org/aboutus

OPEC. (2009b). *Monthly Oil Market Report: 11 August.*

Pham, J. P. (2007, October 2007). Regional Dimensions Of The Human Rights And Humanitarian Situation In The “Ogaden,” Somalia, And Beyond. *Testimony before the United States House of Representatives Committee on Foreign Affairs Subcommittee on Africa and Global Health* . The Nelson Institute for International and Public Affairs James Madison University.

Robock, S. (1971). Political Risk: Identification and Assessment. *Columbia Journal of World Business* (July-August), 6-20.

Ryu, A. (2007, July 25). *Ethiopia Order Red Cross to Leave Ogaden Region.* Retrieved August 15, 2009, from Vocie of America (VOA): News: http://www.voanews.com

Sellassie Family Web. (2009). *List of all Registered Political Parties*. Retrieved September 20, 2009, from Sellassie Family Web: http://www.angelfire.com/ak/sellassie/politics/parties.html

Sickafus, E. (2006). A Simple Theory Underlying Structured, Problem Solving Methodologies. *Second TRIZ Symposium August 31 - September 2.* Suita, Osaka, Japan.

Simon, H. A. (1986). *Decision Making and Problem Solving: Report of the Research Briefing Panel on Decision Making and Problem Solving.* Washington, DC: National Academy of Sciences.

Simon, J. D. (1984). A Theoretical Perspective on Political Risk. *Journal of International Business Studies* (Winter), 123-143.

Société Générale. (2009, September 24). *About Us*. Retrieved September 24, 2009, from Société Générale: http://www.societegenerale.com/en/about-us

SouthWest Energy. (2009). *SouthWest Energy Highlights*. Retrieved July 06, 2009, from SouthWest Energy: Energy for Africa: http://www.sw-oil-gas.com/executive_summary.htm

Tadesse, T. (2009, October 1). *Ethiopia says no rebel risk to Ogaden oil search*. Retrieved October 10, 2009, from Reuters: http://uk.reuters.com/article/idUKL158058420091001

Temin, J. (2006). *Grassroots Conflict Assessment of the Somali Region, Ethiopia.* CHF International.

The Economist. (2003). Another Day at the Office. *The Economist* (May 03), p. 71.

The Economist. (2008, September 18). *Oil, Politics and Corruption.* Retrieved July 10, 2009, from The Economist: http://www.economist.com/PrinterFriendly.cfm?story_id=12080765

The Guardian. (2009, April 21). *Country Profile: Ethiopia.* Retrieved August 15, 2009, from The Guardian: http://www.guardian.co.uk/country-profile/ethiopia/print

The Reporter. (2009, September 29). *Petronas starts drilling first well in Ogaden, Ethiopia*. Retrieved October 10, 2009, from The Reporter: http://www.ezega.com/News/NewsDetails.aspx?Page=heads&NewsID=1738

Thompson, D. (Ed.). (1995). *The Concise Oxford English Dictionary.* New York: Oxford University Press.

USAID. (2005, April). *Youth and Conflict: A toolkit for intervention.* Retrieved August 22, 2009, from http://www.usaid.gov/our work/cross-cutting programs/conflict/publications/docs/CMM Youth and Conflict Toolkit April 2005.pdf

Venter, A. (1997). *An Assessment of Micro-Political Risk: Reasoned Decision Making as a Management Tool.* Retrieved August 04, 2009, from UNISA: http://www.unisa.ac.za

Vertzberger, Y. Y. (1998). *Riak Taking and Decisionmaking: Foreign Military Intervention Decisions.* Stanford: Stanford University Press.

Wells, L. T., & Gleason, E. S. (1995). Is foreign infrastructure investment still risky? *Harvard Business Review* (September-October), 44-55.

Wood, D. (2009, May 20). *Doing Business in a Volatile World.* Retrieved September 26, 2009, from Treasury & Risk: The Future of Finance Today: http://www.reasuryandrisk.com/Issues/2009/May%202009/Pages/Doin-Business-in-a-Volatile-World.html

World Bank. (2009, April 01). *Ethiopia Country Brief.* Retrieved August 15, 2009, from World Bank: http://web.worldbank.org

APPENDIX A

Ogaden Timeline 1850-2005

1850-1920	•Ethiopia under Imperial Rule
1920-1977	•Ethiopia under rule of Haile Selassie
1955	•Revised Constitution dispossesses pastoralists of their land by making it state land
1964	•War between Ethiopia and Somalia partially over Somali Region
1972-1974	•*Lafaad* drought in Somali Region
1977-1978	•War between Ethiopia and Somalia partially over Somali Region
1977-1991	•Ethiopia under Dergue rule
1984-1985	•*Dabadheer* drought in Somali Region
1991	•EPRDF comes to power in Ethiopia; collapse of Siyaad Barre regime in Somalia; return of many Ethio-Somalis to Ethiopia
1994	•*Hurgufa* drought in Somali Region
1995	•New Ethiopian Constitution maintains that all land is nationalized; regional capital moved from Gode to Jijiga
1998	•Formation of Somali People's Democratic Party
1999	•Somali Regional State formalizes *guurti* elders
1999-2000	•*Shanqadhai / Dabagunud* drought
2005	•Land Administration Proclamation entrusts power of administering land to regional state

Table 6: Ogaden Timeline 1850-2005, Appendix A [111]

[111] Temin, 2006, p. 4

APPENDIX B

Political Risk Factors Affecting the Energy Sector		
	Macro - Variables	**Micro - Variables**
Political / Government	• *War and Security Issues (1,2)* • Coups d'Etat • Exiled Opposition • Human Rights Issues • Diplomatic Issues • *Regime Stability (1,2,3,4)* • Fiscal Policy • Protectionism & Trade Barriers • Taxation System • *Repatriation Restrictions (1)* • Excessive Bureaucracy • Monetary Devaluation • Monetary Policy • Legislation Mechanism • Boycotts • Political Spectrum Fractionalisation • Xenophobia & Nationalism • Strength of Radical Left Front • *Authoritarianism (3)*	• Level of Privatisation • Import/Export Restriction • *Investment Constraints (1)* • Reserve Requirements • Restriction on Flow of Funds • Free Trade Zones • Interstate Conflict & Cooperation • Lobbying Efforts
Economic	• Poverty • Unemployment • Interest Rate Volatility • *Balance of Payments (1)* • *Real GDP Growth rate (4)* • Income Distribution • *Currency Convertibility (4)* • *Communications Infrastructure (3)* • Economic Geography • *Creditworthiness (4)* • Rate of Gross Capital Formation • *Economic Stability (1,3)* • *GDP per Capita (4)*	• *Energy Vulnerability (1)* • Prime Lending Rates • Debt/GDP Ration • Debt Service/FOREX Earnings • Current Account % of GDP • Official Reserves % of Debt Service • Reserves Coverage of Imports • Regional Trade Agreements Sectoral Distribution of GDP • Reinvestment Rate • Industrial Development • *Current Account Deficit (1)*
Social	• *Corruption (3)* • *Civil & Labour Unrest (1)* • International Terrorism • *Internal Violence (1)* • Widespread Crime • Wage Rates • Labour Productivity	• *Environmental Activism (1)* • Protection of IRPs • Degree of Fragmentation • Constellations of Power in Society • Age Composition • Level of Unionisation • Technological Development
IHS Energy Group Country Risk Assessment (1)		***Control Risks Group Index (3)***
BP Country Security Risk Assessment Index (2)		***Shell Oil Company's Risk Indicators (4)***

Table 7: Political Risk Factors Affecting the Energy Sector, Appendix B [112]

[112] Adapted from Alon et al. 2006, p. 628, Table 1

Key Variables Relevant to the Oil and Gas Industry	
Risk	**Factors and Indicators**
Host Political Risk	***Governmental/Political*** • Dominant ideology and possible changes • Institutional development, including the strength of the legal system, the legitimacy of the government, and the degree of bureaucratisation • Instability, including the existence of disaffected groups, governmental use of coercion and suppression, and the outbreak of violence • Continuity and changes in leadership, and in the perspective of other major political leaders and/or parties • Nationalism • Domestic and foreign policies, including goals and policy changes • Governmental corruption ***Economic*** • Economic performance, including levels and growth in GNP per capita and inflation • Balance-of-payments and import/export concerns • Foreign exchange position • Public/private sector mix • Level of development and development plans • Government debt • Distribution of wealth • Role of foreign oil firms in the domestic economy • Integration between petroleum/gas industries and the remainder of the national economy • Importance of petroleum to government revenues and the overall economy ***Socio-Cultural*** • Homogeneity: ethnic, linguistic, racial, and national • Standard of living • Receptiveness to foreign influences ***Petroleum Specific*** • Ownership • Domestic reserves/production • Host's relative market position • Level and destination of exports • Strength of national oil company • Role of the foreign firm in the national oil industry • Prices • Domestic ability to operate the industry, including the necessary skills, technology, know-how, and capital • Ownership/contractual relationship between the firm and the host

Key Variables Relevant to the Oil and Gas Industry	
Risk	**Factors and Indicators**
Corporate Political Risk	• Nationality of the company • Positioning in the world industry, including sources of crude, reserves, production, and market outlets • Special bargaining advantage: technology, managerial skills, services, and capital • Dealings with host government: receptive, diplomatic, and open, or unreceptive, brusque, and unyielding
External / International Political Risk	• Host government participation in international treaties, conventions and organisations • Political/economic relationship between the host and the home government, including security, trade, and aid issues • World petroleum market conditions: price, supply, and demand consumption • World economic condition, including economic growth and energy consumption • Developments in other oil-exporting countries (demonstration effect)

Table 8: Key Variables Relevant to the Oil and Gas Industry, Appendix B [113]

[113] Adapted from Lax, 1983, p. 112-3

APPENDIX C

Macro/Micro Risk Analysis Using Critical Indicators			
Factor	**Macro-Indicators**	**Weight**	**Score**
Political / Governmental	War & Security Issues		0-10
	Regime Stability		0-10
Economic	Inflation		0-10
	Exchange Rate Volatility		0-10
	Economic Stability		0-10
	GDP Per Capita		0-10
	Balance of Payments		0-10
	Real GDP Growth Rate		0-10
	Currency Convertibility		0-10
Social	Social Revolutions		0-10
	Corruption		0-10
Factor	**Macro-Indicators**	**Weight**	**Score**
Political / Governmental	Industry Regulatory Bodies		0-10
	(Appropriate Political /Governmental Micro Variables)		0-10
Economic	Energy Vulnerability		0-10
	(Appropriate Political /Governmental Micro Variables)		0-10
Social	(Appropriate Political /Governmental Micro Variables)		0-10
		TOTAL	

Table 9: Macro/Micro Risk Analysis Using Critical Indicators, Appendix C [114]

[114] Alon et al. 2006, p. 640, Table 3

APPENDIX D

Guideline for Security Situation	
Extreme (81-100)	The severity of security risk to assets or personnel is likely to make investment operations untenable. There is no law and order, and conflict[115] conditions may verge on war or civil war. Foreign companies must strongly consider withdrawal. In the absence of effective government control, terrorist groups or insurgent groups operate almost unchecked, with acts of terrorism[116] posing a sever threat to Western or government targets. Travel in the country/region is dangerous and should be avoided. In some cases, travel may be possible if undertaken following professional security advice and if rigorous and comprehensive security measures are in implemented. The authorities are unable or unwilling to provide protection. With high levels of violence or terrorism, foreign travellers will be targets.
High (61-80)	There is a probability that foreign companies will face security problems, and thus special measures are required. Assets and personnel are at constant risk from violence or theft by state or non-state actors. Alternatively, there is a high risk of collateral damage from terrorism or other violence. State protection is very limited. While law and order is generally satisfactory there is a sustained conflict in the form of a terrorist campaign by one or more terrorist groups either against the government or against Western targets. Travel in the country/region is difficult and requires planning. State or non-state actors are likely to disrupt travel; protection from the authorities is inadequate. Terrorism, political unrest, or high levels of violent crime (including kidnapping) pose a serious risk, with foreign travellers likely to be targeted or at increased risk of incidental exposure to violence.
Medium (41-60)	There is a reasonable possibility of security problems affecting companies, but there is no sustained threat directed specifically against foreign companies. Targeted crime or violence posses some risk to foreign assets and personnel, alternatively they are at reasonable risk from violence by terrorists or unrest. State security is inadequate as domestic terrorist groups are active, and/or the country is an obvious target for international Islamic extremist groups. The domestic situation provides a fertile environment for attacks against Western targets. Travel in the country/region is possible but may be subject to disruption by state or non-state actors; these may pose a physical risk. Levels of violent crime (including kidnapping) and/or terrorist attacks pose some risk: caution is required.
Low (21-40)	Investment assets are generally secure and the authorities provide adequate security. Companies and personnel face only infrequent exposure to violence from terrorists or criminals and are unlikely to be systematically targeted for asset theft. The country has few if any domestic terrorism groups and/or is not a viable target for Islamic extremist terrorist groups. Travellers in this country/region face few problems. There is a possibility of disruption by state and non-state actors (such as demonstrations), though these pose little physical threat. Common-sense precautions will minimise the risk from crime, and any low-level terrorist campaign poses only incidental risk to travellers.

Table 10: Guideline for Security Situation, Appendix D [117]

[115] Conflict here may refer to wars, both international and civil, as well as significant communal and/or ethnic conflict, with violent rebel and dissident groups.

[116] Acts of terrorism include the use of violence that may include kidnappings, as well as bombing and shootings in all parts of the country, not only conflict zones. These acts of terrorism, which are driven by ideological, religious, or political goals, target civilians and have no regard for civilian casualties.

[117] Adapted from Control Risks four-star rating for risk (Extreme, High, Medium and Low Risk) and evaluation of four main areas of security (Political, Security, Terrorism Risk, and Travel Risk) (Control Risk, 2009c)

Guideline for Investment Situation	
Extreme (81-100)	Conditions are hostile to or untenable for business, with no investment security. The following conditions may apply: the economy has collapsed; law and order has broken down; state bodies cease to function; there is a state of war or civil war; non-state actors cause suspension of operations; or the state is actively hostile to foreign investments and expropriation of assets is likely.
High (61-80)	Investment is possible but conditions are difficult or likely to become so in the near future. There is little security for investments. Investments may be exposed to the following risks: economic and political conditions may become rapidly unstable; international sanctions are possible, non-state actors actively target foreign investments, or there is a risk of contract repudiation or renegotiation by state actors.
Medium (41-60)	Foreign investment is likely to face some disruption from state or non-state actors. Long-term security cannot be guaranteed. There is a risk for investment exposure to some or all of the following; corruption, strong and hostile lobby groups, absence of adequate legal guarantees, restrictions on imports or exports; weak political institutions, and capricious policy-making. In some medium risk countries, there is the latent threat of military or other legal action.
Low (21-40)	Investments can operate with few problems: political institutions are stable but there is some possibility of negative policy change; legal guarantee are strong but business may face some regulatory or judicial insecurity; non-state actors may occasionally hamper operations.

Table 11: Guideline for Investment Situation, Appendix D [118]

[118] Adapted from Control Risks four-star rating for risk (Extreme, High, Medium and Low Risk) and evaluation of four main areas of security (Political, Security, Terrorism Risk, and Travel Risk) (Control Risk, 2009c)

Guideline for Political and Economic Situation	
Extreme (81-100)	Political: There is a breakdown in government control over the entire territory. There is consistent opposition to the authorities coupled with violent oppression by the authorities. Sustained human rights abuses are prevalent, with continued violence regarding political issues/protests. Economic: There is a complete breakdown of economic systems with uncontrolled inflation, currency failure, exchange rate mechanism failure, uncontrolled interest rates, failure of banking system, and a large grey economy.
High (61-80)	Political: The political system is considered disruptive, with uncertainty and/or instability. There is countrywide civil opposition with more than frequent violence due to political issues/protests. Human rights abuses are sporadic. Economic: The economic system is unstable with macroeconomic imbalances, rising inflation, fiscal deficits, multiple official exchange rates, distorted interest rates, inability to reconcile national accounts, frequent banking collapse, and a medium grey economy.
Medium (41-60)	Political: The political system is considered to be functioning, with free and fair elections, however more than usual changes of government in power occur. There are some instances of civil unrest due to political issues. Human rights abuses are minimal if any at all. Economic: The economic system is relatively stable with average inflation and interest rates, even banking system with sporadic if any banking collapse, and above average grey sector economy.
Low (21-40)	Political: Here a full functioning political system exists, with free and fair elections, and freedom of speech. There is vocal opposition on political issues and few if any instances of non-violent civil unrest. No human rights abuses occur. Economic: The economic system is considered very stable with controlled below average interest rates and inflation, a solid banking system and exchange rate mechanisms, and a minimal grey economy.

Table 12: Guideline for Political and Economic Situation, Appendix D